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Regulatory Competition in Securities Law: A Dream (That Should Be) Deferred

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Proponents of regulatory competition have presented their most detailed arguments in the field of corporate law, but have also made a similar case in other areas, including securities regulation. Proponents of regulatory competition in securities regulation argue that our markets would be best served if (a) states or nations competed to provide legal regimes to govern securities transactions, or (b) domestic or international securities exchanges competed for listings of companies whose transactions would be governed by the rules of the exchange. Theoretically, states and other nations would compete to provide legal regimes governing securities transactions, or perhaps exchanges could compete for listings by offering varieties of legal regimes for securities transactions. Companies could then choose to be governed by the laws and/or listing requirements that best accommodate their needs. This Article is the first to comprehensively discuss all of these various manifestations of regulatory competition in securities law. It demonstrates that in all of these forms, true competition is likely to be insufficient and likely to represent a stroll toward the bottom rather than a race to the top. Providers of regulation are insufficiently motivated to provide innovative and efficient regulatory schemes. More significantly, managers functionally choose where to incorporate or where to list, meaning that, in a system of regulatory competition, the fox determines which rules will govern the operation of the henhouse. A significant amount of empirical evidence supports the notion that the best regulatory model is the current strong-SEC regulatory model that other nations have begun to strongly emulate. Capital markets would be better served by efforts to improve the strong-SEC model than by attempting to replace it with regulatory competition.

I. INTRODUCTION

There are three competing visions for the future of securities regulation: (a) private contracting, (b) regulatory competition, and (c) what I term the "strong-SEC" model.

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The private contracting model calls for substantially lessened governmental regulation of the securities markets based upon the notion that market participants can voluntarily contract for the most efficient levels of disclosure and fraud protection.[1] I have objected previously to the private contracting model, articulating arguments based upon principles derived from behavioral law and economics.[2] I have also made the case for a "strong-SEC" model.[3] What I have not done is directly address the regulatory competition model, a notable oversight given that no other proposal for shaping the future of securities regulation has received more academic attention over the last quarter century.[4]

The theory of regulatory competition has had its most prominent explication in the area of corporate law. Proponents believe that business firms would be best served if either states or nations competed for incorporations. The idea is that there would be a "race to the top" as these various regimes attempted to best each other by writing ever more efficient rules of law that would attract incorporations by firms hoping to serve their shareholders' interests well.

Proponents have exported regulatory competition to many other areas of law, including, importantly for purposes of this Article, securities regulation. Proponents of regulatory competition in securities regulation argue that our markets would be best served if (a) states or nations competed to provide legal regimes to govern securities transactions, or (b) securities exchanges competed for listings of companies whose transactions would be governed by the rules of the exchange. Theoretically, states and other nations would compete to provide legal regimes governing securities transactions, or

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[1] *See, e.g.*, Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal*, 88 CAL. L. REV. 279, 279 (2000) (suggesting that securities professionals be totally deregulated and investors be regulated instead).

[2] Robert A. Prentice, *Contract-Based Defenses in Securities Fraud Litigation: A Behavioral Analysis*, 2003 U. ILL. L. REV. 337 (2003) (criticizing cases allowing law investors to contract away the securities laws' fraud protection); Robert A. Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397 (2002) (directly addressing Choi's proposal for regulating investors).

[3] *See* Robert A. Prentice & Frank Cross, The Economic Value of the SEC and Mandatory Disclosure Requirements (2005) (on file with author) (making an empirical argument for the strong-SEC model); Robert A. Prentice, *The Inevitability of a Strong SEC*, 91 CORNELL L. REV. (forthcoming May 2006) (making the nonempirical case for the strong-SEC model).

[4] *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 384 (2003) (noting that the notion that state competition creates a "race to the top" in American corporate law "appears to dominate the current thinking of corporate law academics . . .").

perhaps exchanges could compete for listings by offering varieties of legal regimes for securities transactions. Companies could then choose to be governed by the laws and/or listing requirements that best accommodated their needs.

In these alternative regimes, the SEC would be largely unnecessary. Professors Romano, Choi, and Guzman, among others, have argued that most everyone would gain if companies could choose to opt into a variety of regimes containing much lower (and much less expensive) disclosure and governance requirements than those promulgated by the SEC. In their desired world, issuers could choose any regulation, or even no regulation.[5]

The purpose of this Article is to address the most recent theoretical and empirical evidence regarding the viability and directionality of regulatory competition in modern securities markets and to speculate about the state of affairs that might ensue if the current strong-SEC model were replaced. This is the first Article to look at securities regulatory competition in all of its theoretical forms, to demonstrate the ubiquity of the downward direction of that competition, and to provide a clear theory to explain the empirical evidence.

Part II reviews the familiar debate over state regulatory competition in the corporate law field that has served as a basis for extension of the model to other fields. Part III examines the state regulatory competition model as extended to securities regulation. Part IV looks at the international regulatory competition model for securities regulation. Part V appraises regulatory competition among domestic securities exchanges. Part VI analyzes regulatory competition among all securities exchanges, foreign and domestic.

The picture that the evidence paints in each of these areas is one of little meaningful regulatory competition and, to the extent that any competition exists, a relaxed stroll to the bottom rather than a race to the top. Part VII provides some explanations for the observed trends and draws some inferences regarding the future of securities law under a world of regulatory competition.

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[5] *See* Frederick Tung, *From Monopolists to Markets?: A Political Economy of Issuer Choice in International Securities Regulation*, 2002 WIS. L. REV. 1363, 1367–68 [hereinafter Tung, *Monopolists*] (noting the free market goals of regulatory competition enthusiasts).

Coffee also likes the idea of regulatory competition, but believes that it may well lead to higher and more uniform, rather than lower and more diverse, standards. *See* John C. Coffee, Jr., *Racing Towards the Top?: The Impact of Cross-Listings and Stock Market Competition on International Corporate Governance*, 102 COLUM. L. REV. 1757 (2002) [hereinafter Coffee, *Racing Towards the Top*]; John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999) [hereinafter Coffee, *Future as History*].

This Article will challenge many of the assumptions of regulatory competition. One such assumption, that states (or nations) will behave like profit-maximizing firms and thereby produce optimally efficient corporate law, was recently disputed by Hadfield and Talley in a paper in which they suggested that private companies would be more properly motivated providers of efficient law.[6] While they provide persuasive reasons to doubt the assumption that *providers* of corporate law are optimally motivated, this Article focuses more centrally on the equally dubious assumption that the *buyers* of corporate and securities law are optimally motivated to purchase efficient rules.[7] Almost all corporation law and much securities law exist to solve the classic agency problem, to restrain agents from benefiting at the expense of their principals. Yet regulatory competition functionally allows agents to select the rules that will govern their actions. In so doing, it simply assumes away this well-established agency problem and functionally allows the foxes to establish the rules that will govern the henhouse. This major flaw is the primary reason that state and national regulatory competition (or private contracting, for that matter) should not be the focus of efforts to improve corporate and securities law. Fortunately, while many academics have mired themselves in a debate over regulatory competition, few real world actors have taken it seriously, enabling Part VIII of this Article to sound a hopeful concluding note.

II. STATE CORPORATE LAW COMPETITION

The various securities law competition models that are the primary focus of this Article are derived from the familiar state *corporate law* competition

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[6] Gillian K. Hadfield & Eric L. Talley, *On Public Versus Private Provision of Corporate Law* 11 (Univ. S. Cal. Law & Econ. Research Paper Series, Research Paper No. 04–18; Univ. S. Cal. CLEO Research Paper Series, Research Paper No. C04–13, 2004), *available at* http://ssrn.com/abstract=570641 (challenging the "central premise of the regulatory competition literature [which] is that legislators (and other public actors) effectively behave like profit-maximizing firms, choosing laws and regulations that maximize state 'profits'").

[7] *See* Frederick Tung, *Passports, Private Choice, and Private Interests: Regulatory Competition and Cooperation in Corporate, Securities, and Bankruptcy Law*, 3 CHI. J. INT'L L. 369, 370 (2002) [hereinafter Tung, *Passports*] (assuming, for purposes of his argument, that providers of securities law are not motivated to provide the most efficient law, that the firm managers are motivated to choose legal regimes in order to maximize firm value).

The problem with buyers explains why Hadfield and Talley's private contracting solution is not workable. *See* Hadfield & Talley, *surpa* note 6. But that issue will not be addressed here.

model,[8] which was forged in the heat of a debate between William Cary and Ralph Winter regarding whether state competition for corporate charters would likely lead to a "race to the top" in which state legislatures would compete for corporate charters by providing default rules that favored shareholder interests (Winter's view)[9] or a "race to the bottom" in which state legislatures would compete by enacting default rules that favored managers' interests at the expense of shareholders (Cary's view).[10] Both articles and many that followed were based on an assumption that meaningful levels of such competition existed. Perhaps the fact that no one could determine with any certainty which direction the competition was flowing should have been a hint that it was not, in fact, a significant force.

A. *No Meaningful Competition Exists*

Both Cary[11] and Winter[12] gained adherents to their points of view, but the evidence that significant competition for incorporations occurs among the states has been largely indirect. Much of the case made by Professor Romano, for example, has always been based on statistics about firms that *reincorporated*. Reincorporation is not a frequent event, so generalizing from this atypical category is obviously questionable.[13]

In discussing incentives for states to engage in such competition, Romano has focused nearly exclusively on Delaware's revenues from

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[8] To a large extent these models are, in turn, based upon the Tiebout model of public goods provision. Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956). This model has been undermined by evolving economic thinking in a recent article that "highlights the hollowness of the [Tiebout] model's assumption that government actors have incentives to act entrepreneurially." William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 206 (1997).

[9] Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

[10] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974).

[11] *See, e.g.*, Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) [hereinafter Bebchuk, *Desirable Limits*].

[12] Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982).

[13] *See* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1568 (2002) [hereinafter Daines, *Incorporation Choices*] ("[B]ecause the subset of reincorporating firms is not a random sample of public firms, it is hard to generalize the results.").

incorporations,[14] but has necessarily ignored the fact that despite the theoretical incentive to compete with Delaware, no other state, with the possible minor exceptions of Maryland and Nevada, has in recent years genuinely sought to gain revenue in the same fashion.[15]

The fact that no state other than Delaware gains any significant franchise tax revenue by attracting incorporations renders largely meaningless the related argument that there is a correlation between a state's total tax collections coming from the franchise tax and the speed with which its legislature enacts certain corporate law reforms.[16]

Virtually all companies incorporate initially either in their home states or in Delaware, so states other than Delaware have little to gain, revenue-wise, by enacting efficient corporate law. All things being equal, states would, of course, wish to retain the incorporations they already have. However, those incorporations generate a very modest amount of revenue for most states and, as noted, reincorporations are quite rare. Between 1978 and 2000, over 6000 firms went public,[17] yet only 600 or so of all existing public companies reincorporated,[18] meaning that states generally need not be particularly concerned about losing the incorporations they already have.

Romano has noted that "[i]nnovations in corporation codes that firms emphasize as provisions leading them to change their incorporation state spread rapidly across the states in a pattern resembling the S-shaped diffusion curve of technological innovations,"[19] drawing the nonobvious conclusion that states must be competing for incorporations. She ignores the fact that

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[14] ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6–7 (1993) [hereinafter ROMANO, GENIUS].

[15] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 687–88 (2002) ("In all states other than Delaware, . . . franchise taxes are not structured to raise substantial revenues from incorporations, even if a state succeeded in attracting a substantial fraction of publicly traded companies.").

[16] After an exhaustive study, Kahan and Kamar note: "Delaware aside, no state gains material franchise tax revenues by attracting incorporations. Since incorporations do not increase franchise taxes, the correlation between franchise taxes and the enactment of corporate law innovations cannot be caused by more responsive states attracting more incorporations." *Id.* at 700. *See also* Daines, *Incorporation Choices*, *supra* note 13, at 1574 (noting that because states outside Delaware have structured their franchise taxes based on business done in-state, "incorporations have no meaningful impact on the state's marginal revenue").

[17] Daines, *Incorporation Choices*, *supra* note 13, at 1569.

[18] *Id.*

[19] ROMANO, GENIUS, *supra* note 14, at 16.

most kinds of law, including those where no competition could remotely be occurring, diffuse in the same manner.[20]

The most obvious way that other states could compete with Delaware would be to create a special corporate court system to compete with Delaware's chancery courts, yet few other states have made the effort to do so.[21] Nor is there any evidence of judicial competition.

Furthermore, to the extent that there are modest differences in statutory law from state to state, they do not seem to be directed principally to the goal of attracting incorporations. Rather, they are done to satisfy local political constituencies, such as owners of local closely held corporations or managers of local public corporations.[22]

Thus, it appears that over the years, both sides of the race-to-the-top/race-to-the-bottom debate simply lost sight of the forest for the trees. Fortunately, in three recent articles, authors have stepped back to see the big picture and it is this: *there is no meaningful competition among the states for incorporations*. State corporate competition is largely a myth.[23]

Delaware wishes to maintain its preeminent position as the most important site for incorporations; other states do not seem particularly motivated to attempt to dethrone the reigning champ. If any would like to make a serious run at doing so,[24] they are not taking any significant steps

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[20] Kahan & Kamar, *supra* note 15, at 715–16 ("Many statutory innovations in areas where states do not compete diffuse among states along ogive [(S-shaped)] curves. These areas include welfare, health, education, conservation, planning, administrative organization, highways, civil rights, corrections and police, labor, taxes, and professional regulation. Even abortion laws exhibit a similar pattern of diffusion.").

Kahan and Kamar also studied the diffusion of important Model Business Corporation Act provisions and found no evidence supporting Romano's theory. *Id.* at 702.

[21] *Id.* at 708–15.

[22] *Id.* at 701–24.

[23] *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 555 (2002) ("The alleged vigorous race among states vying for incorporations, we argue, simply does not exist."); Daines, *Incorporation Choices*, *supra* note 13, at 1562 ("[T]he dominant metaphor of a national race between fifty states or a single market with fifty producers is incorrect and potentially misleading."); Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 634 (2004) (concluding that state-to-state competition in the corporate governance field is "illusory"); Kahan & Kamar, *supra* note 15, at 684 ("[T]he very notion that states compete for incorporations is a myth. Other than Delaware, no state is engaged in significant efforts to attract incorporations of public companies.").

[24] One may argue that Nevada and Maryland have an interest here, but Maryland's interest seems to be limited to attracting mutual funds. *See* Kahan & Kamar, *supra* note

toward attaining that goal and it probably would not do them any good to try, because Delaware enjoys formidable advantages.[25]

Simply put, Delaware won the "competition" for incorporations decisively and long ago.[26] Its "dominance is staggering."[27] Eighty-five percent of all "out-of-state" incorporations occur in Delaware.[28] Viewed another way, ninety-seven percent of companies incorporate either in their home state or in Delaware.[29] States do not meaningfully compete for the other three percent[30] and there is no strong reason why they should.[31] As each year goes by, Delaware's advantage, now a century in the making, grows larger.[32]

Because of the lack of competition, differences in corporate law among the other forty-nine states are minor and generally unimportant.[33] The states tend to imitate, rather than innovate.[34] Even Romano admits that the "substantive content [of the fifty state corporation codes] is substantially

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15, at 721–22. Nevada seems to target only close corporations, and "with regard to public corporations Nevada has done little, derived minuscule benefits, and had trivial success." *Id.* at 718. Nevada's fee revenues from public incorporations is only $26,200 per year and its market share of IPO incorporations is 1.1% and falling. *Id.* at 720.

[25] Bebchuk & Hamdani, *supra* note 23, at 597 ("[B]arriers to entry, network effects, large sunk costs, managerial control over reincorporation decisions, and the risk of strategic response by Delaware will deter rival states from mounting a meaningful challenge to Delaware in the ordinary course of events.").

[26] *See* Daines, *Incorporation Choices*, *supra* note 13, at 1572 ("Delaware law governs more than 97% of assets of public firms incorporated outside of their home state, while *together*, Delaware's nearest four rivals split 0.6% of the market between them.").

[27] Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, 67 LAW & CONTEMP. PROBS. 135, 136 (2004) (noting that 300,000 companies are incorporated in Delaware, including 300 of the Fortune 500; New York has the next highest number of Fortune 500 companies with 25); *see* Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimating Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 143 (2004) (noting that Delaware has no meaningful rivals).

[28] *See* Jones, *supra* note 23, at 632.

[29] *See* Daines, *Incorporation Choices*, *supra* note 13, at 1562.

[30] *See* Bebchuk & Hamdani, *supra* note 23, at 581 ("[S]tates have not even structured their incorporation taxes and fees in a way that would provide them with meaningful benefits if they were to attract many out-of-state incorporations.").

[31] *See* Daines, *Incorporation Choices*, *supra* note 13, at 1574 (noting that "[t]he financial consequences to states of attracting out-of-state firms are trivial . . .").

[32] *See* Michael Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127, 169 (2004) (noting that because of economies of scale and network effects, "as the number of firms incorporated in Delaware increases, the value of its charter increases").

[33] *See* Daines, *Incorporation Choices*, *supra* note 13, at 1583.

[34] Bebchuk & Hamdani, *supra* note 23, at 606.

uniform."[35] The picture that state corporate law competition advocates paint of legislators toiling away to produce innovative and efficient corporate governance codes in order to attract out-of-state incorporations and attendant tax revenue is mostly an illusion.

B. *Race to the Bottom*

States do, of course, offer corporation laws to their companies, but primarily as a service to them.[36] All things being equal, one supposes that legislatures would prefer to pass efficient laws, but there is no strong reason why they should compete to do so in this setting. If they are playing a competition game to some modest extent, their primary motivation must be to maximize revenues, rather than to produce the most efficient corporate law.[37] Looking on the supply side and thinking in terms of public choice literature, there is no compelling reason to believe that individual legislators will be adequately motivated to provide efficient corporate law.[38]

Looking on the demand side, there is every reason to believe that legislators, to the modest extent that they might be motivated to gain revenue for their jurisdictions, tend primarily to react to the desires of the managers of corporations. Managers, not shareholders, make the consumption decision. Because managers have an effective veto over incorporation and reincorporation decisions,[39] "[t]he existing state of affairs . . . provides Delaware with incentives to offer rules that managers favor, even if such rules are not the ones most favorable to shareholders."[40]

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[35] ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 21 (2002) [hereinafter ROMANO, ADVANTAGE].

[36] Bebchuk & Hamdani, *supra* note 23, at 582.

[37] *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 228 n.3 (1985) (noting that the competition literature generally has not specified what it is the states are attempting to maximize).

[38] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 216 (1991) [hereinafter EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE] (noting that "[n]o legislator can capture the benefits to the state of increased revenue . . ."); Hadfield & Talley, *supra* note 6, at 3 (pointing out that because individual legislators do not benefit directly from more incorporations, it is hard to see how they are "spurred" to produce efficient law).

[39] *See* Bebchuk & Hamdani, *supra* note 23, at 592 (making this point).

[40] *Id.* at 600.

1. *A Brief History*

Delaware acquired the mantle of leading corporation jurisdiction when Governor Woodrow Wilson of the mantle's previous wearer, New Jersey, attempted to enforce antitrust laws against the abusive trusts that had made New Jersey their haven.[41] These corporations had originally moved to New Jersey when it amended its corporate law to allow corporations to do what other states denied them—own stock in other corporations and thereby create the giant trusts of the late 1800s.[42] After Wilson's impertinence, these corporations simply moved to Delaware and have been there ever since.[43] Delaware strengthened its grip on the leading position in 1929 when it reduced the requirement for shareholder approval of asset mergers from a supermajority to a simple majority, giving managers much more discretion than they previously had enjoyed to effectuate such transactions over substantial shareholder objection.[44] After losing some of its lead, Delaware regained it by making another round of pro-manager amendments in the 1960s.[45]

In other words, in every round of active state competition for charters that occurred before the 1980s, first New Jersey and then Delaware won by granting managers more and more discretion and leaving shareholders fewer and fewer protections. This is not to say that all of the decisions were bad or inefficient, only that the motivating force was obvious.

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[41] At the time, the U.S. Industrial Commission examined whether federal incorporation or other federal regulation of corporations would be a good idea, noting that some states "have apparently, for the sake of securing a certain revenue easily collected, bid against each other by offering more liberal inducements to corporations." INDUS. COMM'N FINAL REP. 643 (1902). The report noted that this "demoralizing tendency in corporation legislation . . . makes the task of controlling large corporations exceedingly difficult." *Id.*

[42] DAVID A. SKEEL, JR., ICARUS IN THE BOARDROOM: THE FUNDAMENTAL FLAWS IN CORPORATE AMERICA AND WHERE THEY CAME FROM 63–64 (2005).

[43] *Id.* at 65.

[44] Katharina Pistor et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791, 813–14 (2002).

[45] *See* William W. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism* 20–21 (European Corporate Governance Inst. (ECGI) Law Working Paper Series, Working Paper No. 23, 2004), *available at* http://ssrn.com/abstract=606481 [hereinafter Bratton & McCahery, *Equilibrium*].

2. *Recent Innovations*

a. *Antitakeover Legislation*

The most recent round of state corporate code innovations occurred in the 1980s.[46] The largest part of the innovation involved takeover rules. By this time, it was too late for any other jurisdiction to overtake Delaware, so there was no true competition, but, as in other rounds of innovation, the entire purpose was to "cater[] to management's interest in freedom of action."[47] Although regulatory competition proponents have tried to spin the takeover offer law reforms as pro-shareholder,[48] what obviously happened in the 1980s and 1990s was that several states passed antitakeover legislation to protect specific local companies against hostile takeover threats.[49] The state legislatures were not trying to attract incorporations;[50] they were simply attempting to save local companies and attendant jobs and tax revenues.[51] Managers of the companies lobbying for passage of the laws were not looking out for the best interests of shareholders, whose financial interests

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[46] *Id.* at 27–28.

[47] *Id.* at 28.

[48] *See* ROMANO, GENIUS, *supra* note 14, at 52–75. Later, Romano seemed to admit to the fact that most states enacted laws that attempted to lower the probability of a hostile takeover in order to benefit managers, not shareholders, in a manifestation of a "race to the bottom." Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2385 (1998) [hereinafter Romano, *Empowering Investors*].

[49] *See* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 752 (1998) ("[S]tate antitakeover laws may represent cooperative behavior between managers resisting takeovers and legislators seeking both political support and retention of local corporations at the expense of shareholders."); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 (1988) Romano notes:

> The political history of second generation takeover statutes is similar across the states. The statutes are typically enacted rapidly, with virtually unanimous support and little public notice, let alone discussion. They are frequently pushed through the legislature at the behest of a major local corporation that is the target of a hostile bid or apprehensive that it will become a target.

Id.

[50] And, indeed, there is little evidence that antitakeover statutes affect incorporation decisions. *See* Daines, *Incorporation Choices*, *supra* note 13, at 1597.

[51] *See* Kahan & Kamar, *supra* note 15, at 703 (noting that "[e]ven laws not driven by a specific company or a specific bid were intended to protect local companies from takeovers generally").

would have been maximized by allowing such takeovers to proceed and who often opposed such antitakeover measures when they have a chance to vote on them.[52] Rather, the managers were trying to protect the corporate bastion and their own salaries and perquisites. This is not truly an example of state corporate law competition in the sense theorized by advocates,[53] but the actions of the managers were consistent with race-to-the-bottom reasoning.[54]

As Bebchuk has noted: "If antitakeover measures are inefficient, then [race-to-the-top] logic predicts that states will not adopt them. Nonetheless, states have done so overwhelmingly. This divergence between the theory's prediction and the actual practice of states has not gone unnoticed."[55] Indeed,

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[52] In the last decade, shareholders have generally voted to eliminate takeover defenses when they had a chance to vote on the issue. *See* Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance: Active in Proxies, Passive in IPOs* (Stanford Law Sch. John M. Olin Prog. in Law & Econ., Working Paper No. 225, 2001), *available at* http://ssrn.com/abstract=292083.

[53] If this is an example of state competition, then it is clear that states with antitakeover statutes have won it. *See* Lucian Arye Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1820 (2002) ("[T]he empirical evidence does not establish that state competition rewards moderate takeover regimes rather than the amassing of antitakeover statutes."); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1872 (2002) [hereinafter Subramanian, *Influence*] (reporting an empirical study of new incorporations and reincorporations and finding, consistent with a race-to-the-bottom view, that "managers generally migrate to (and fail to migrate away from) the typical state antitakeover statutes").

[54] Although I am not as enamored of the monitoring value of hostile takeovers as most corporate commentators sympathetic with Professor Romano's views, it is important to note that those in her camp criticize state regulation of takeovers as providing a haven for inefficient and fraudulent managers inconsistent with the best interests of shareholders. *See, e.g.*, Larry E. Ribstein, *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 1, 49–50 (2002). While the strongest argument in favor of takeover defenses has been that they enable target management to negotiate with the acquirer for a higher premium, that theory recently has taken a substantial hit. *See* Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J.L. ECON. & ORG. 83, 86 (2001) (finding that IPO entrepreneurs do not add takeover defenses for the purpose of extracting a higher premium in the eventual sale of a company); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621 (2003) [hereinafter Subramanian, *Bargaining*] (noting theoretical evidence, empirical evidence, and statements of belief from leading practitioners that poison pills, staggered boards, and other takeover defenses raise premiums significantly in only a small subset of takeovers).

[55] Bebchuk, *Desirable Limits*, *supra* note 11, at 1446.

Subramanian agrees, noting that "the large-sample evidence shows that managers are able to pursue private benefits of control by moving to states with [antitakeover] statutes.

even some proponents of the race-to-the-top theory concede that behavior in this realm contradicts their essential argument.[56] It is inconsistent to advocate for both an open market for corporate control and state regulatory competition, as many have done.[57]

b. *Officer Liability Protection*

After *Smith v. Van Gorkom* seemingly created a real possibility that directors could be held personally liable for their delicts,[58] officers and directors demanded protection from accountability to shareholders to whom they owed a fiduciary duty, and state legislatures quickly acceded to those demands.[59] Romano cites these laws as an example of regulatory competition.[60] To the extent that it constitutes competition, a clear signal regarding the direction of this round of legislative changes is that states allowed shareholders to adopt, but not to rescind, corporate provisions to insulate directors from liability for breaches of their fiduciary duty.[61] Delaware led the way in protecting managers, and it has been argued that the reason Delaware continues to dominate the provision of corporate law is that

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States, in turn, can be expected to (and do) cater to this interest." Subramanian, *Influence*, *supra* note 53, at 1873.

In a recent study, Kahan found no significant evidence that antitakeover statutes attracted incorporations, but did find evidence that provisions allowing managers to minimize shareholder approval needed for mergers, minimize director liability, and eliminate cumulative voting do. Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?* 33 (N.Y.U. Law & Econ. Research Paper No. 04-017, June 2004) *available at* http://ssrn.com/abstract=557869. Although he does not read it that way, Kamar admits that a plausible interpretation is that these results evidence a race to the bottom. *Id.* at 34. *See also* Barzuza, *supra* note 32, at 135 ("[I]t has been shown that among states other than Delaware, those that adopt stronger antitakeover protections are more successful in retaining incorporations than states that adopt weaker ones.").

[56] *See* Winter, *supra* note 9, at 287–89.

[57] *See* Bebchuk & Cohen, *supra* note 4, at 388.

[58] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[59] *See* Sean J. Griffith, The Good Faith Thaumatrope: A Model of Rhetoric in Corporate Law Jurisprudence 74 (Dec. 17, 2004) (unpublished working paper), *available at* http://ssrn.com/abstract=571121 (noting that the Delaware legislature's effective overruling of the Delaware Supreme Court's attempt to impose some accountability on directors in *Smith v. Van Gorkom* "fits nicely with the standard political economy account of Delaware corporate law: legislators are sensitive to changes in the law that might cause corporations to leave and, when they can be persuaded that the courts have made such a change, are apt to change it back").

[60] Romano, *Empowering Investors*, *supra* note 48, at 2392.

[61] *See* Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 866 (2003).

it has been "the state where managers turned for assurances of minimal exposure to personal liability for mistakes, misjudgments, wrongdoing, or self-dealing."[62]

Because other public company constituencies (shareholders, employees, customers, bondholders, local communities) are mostly located outside Delaware, the managers of public companies incorporated there have a much stronger voice when lobbying for their interests.[63] That is likely to be the case in any jurisdiction that competes for incorporations. It is telling that the only other jurisdictions that one may plausibly argue have even lightly competed for incorporations with Delaware lately, Nevada and Maryland, have done so on the basis of advertising to managers their minimal disclosure requirements, their liability shields, and their minimizing of shareholder voice.[64]

As Professor Choi recently queried:

> How can we advocate for greater choice in regulatory protection when self-interested managers abuse the limited choice presently available to them? The same impulses that may lead managers to corrupt analysts and auditors through the provision of consulting and investment banking services may also lead managers to opt for progressively weaker investor protection if given the ability to select the governing corporate and securities legal regime.[65]

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[62] Jones, *supra* note 23, at 646. *See also* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 97 (2d ed. 2003) (noting that managers desiring "a sympathetic and experienced ear to the problems of running a public corporation, are assured of finding it in Delaware").

[63] *See* Brett McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 136 (2004) [hereinafter McDonnell, *Two Cheers*] ("[A]t the state [law] level, these other corporate constituencies are probably at the greatest disadvantage in Delaware.").

[64] *Id.* at 109–10 (citing sources indicating that Nevada touts its minimal reporting, minimal disclosure, and greater liability protection for investors, while Maryland focuses on mutual funds, waiving annual shareholder meeting requirements, and giving boards power to issue more shares without shareholder approval).

[65] Stephen J. Choi, *Channeling Competition in the Global Securities Market*, 16 TRANSNAT'L LAW. 111, 112 (2002). Bratton and McCahery make the same point, noting that the race-to-the-top regulatory competition model

> depends on the heroic assumption [that] shareholder and manager interests always are perfectly aligned, rendering irrelevant the mandated agenda control managers enjoy under the state system. Where, as with takeovers, interests do not stand aligned, the state system displays a structural defect. Because the market forces a state that actually competes to focus on the variables that influence incorporation decisions, there follows a concern for management preferences rather than

3. *Empirical Evidence of Directionality*

Regulatory competition advocates respond to all of this evidence by citing studies indicating that corporations reincorporating in Delaware get a positive market boost.[66] However, those studies cannot tease out the impact of substantive corporate law from network effects.[67] Obviously, the more corporations that incorporate in Delaware, the more benefits flow to all that incorporate there regardless of the quality of the substantive law.[68] Indeed, there is every possibility that network and learning effects could cause a lock-in of inferior, inefficient law.[69] The methodological problems of these studies,[70] plus their failure to consider the possibility of increasing returns,[71] leave the evidence inconclusive.

Furthermore, the event studies upon which regulatory competition advocates rely are simply predictions by investors that other investors will

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> shareholder value itself. Accordingly, nothing at the state level prevents suboptimal accommodation of management preferences respecting ex post affiliation terms and fiduciary standards.
>
> Since the defect is intrinsic to the system, regulatory correction must occur at the national level.

Bratton & McCahery, *Equilibrium*, *supra* note 45, at 29.

[66] ROMANO, ADVANTAGE, *supra* note 35, at 63–74.

[67] *See* Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424 (1985) (noting that network effects arise when "the utility that a user derives from consumption of the good increases with the number of other agents consuming the good").

[68] *See* Brett H. McDonnell, *Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects*, 31 HOFSTRA L. REV. 681, 681 (2003) [hereinafter McDonnell, *Stuck*] (noting that "[t]he presence of a variety of network effects may cause corporations to incorporate in a state which already has taken the lead in the charter race, even if some other states might offer better substantive law," but arguing in favor of state competition nonetheless).

[69] *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 849–51 (1995).

[70] *See* Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 VA. L. REV. 993, 1003 n.24 (2001) (noting that the evidence upon which Romano relies "cannot be reliably interpreted as favoring state competition"); McDonnell, *Stuck*, *supra* note 68, at 710–11 (noting numerous problems that events studies have in taking into account the effect of factors other than those being tested).

[71] Even if Delaware has nonoptimal substantive law or even law worse than that of some or most other jurisdictions, its more experienced judges, greater predictability, and general network effect benefits that stem from its dominant position mean that "positive returns to shareholders from incorporation in Delaware [are] quite consistent with the race to the bottom thesis combined with the presence of increasing returns." McDonnell, *Stuck*, *supra* note 68, at 711.

react positively to the move to Delaware, whereas studies that look at the actual economic performance of firms once they reincorporate in Delaware tend not to show improvement.[72] And more recent studies show that even the so-called "Delaware effect" on stock price disappears when examined over time, especially for larger firms.[73]

Additionally, the emerging field of behavioral finance[74] should make one pause before accepting the assumption that higher initial share prices automatically signal more shareholder value.[75] The broad evidence that markets are not as efficient as once believed and that investors often act irrationally calls into question any evidence based simply on stock price. Herd behavior[76] likely causes many firms to incorporate in Delaware.[77]

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[72] *See, e.g.*, Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 188 (1985) (finding no performance advantage to corporations in Delaware); Roberta Romano, *Corporate Law and Corporate Governance*, 5 INDUS. & CORP. CHANGE 277, 322–23 (1996) (finding no improvement in accounting performance upon reincorporation in Delaware); Jianghong Wang, Performance of Reincorporated Firms (Nov. 1995) (unpublished manuscript, on file with the Yale School of Management), *cited in* ROMANO, ADVANTAGE, *supra* note 35, at 221 nn.41, 42.

[73] *See* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 57 (2004) [hereinafter Subramanian, *Disappearing Delaware*] (finding that small Delaware firms were worth more than small non-Delaware firms during the period 1991–1996, but not afterward, and that larger firms—ninety-eight percent of the sample—exhibited no "Delaware Effect" for any year from 1991 to 2002). Subramanian is refuting an earlier study done by Daines. *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

[74] *See* Malcolm Baker et al., *Behavioral Corporate Finance: A Survey* (Oct. 9, 2004) (unpublished working paper), *available at* http://ssrn.com/abstract=602902 (containing a recent, lengthy survey of the field); *see also* HERSH SHEFRIN, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING (2000); ANDREI SHLEIFER, INEFFICIENT MARKETS: AN INTRODUCTION TO BEHAVIORAL FINANCE (2000); ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000); RICHARD H. THALER, QUASI RATIONAL ECONOMICS (1991); LARS TVEDE, THE PSYCHOLOGY OF FINANCE (1999).

[75] *See generally* Lynn A. Stout, *Share Price as a Poor Criterion for Good Corporate Law* (UCLA Sch. of Law, Law & Econ. Paper Series, Paper No. 05–7, 2005), *available at* http://ssrn.com/abstract=660622 (emphasizing inefficiencies in the market and the misleading nature of share price as a guide to production of true economic value).

[76] Herd behavior occurs when people decide to do things largely because others are doing them, not because they have put any independent thought into the decision. Herd behavior influences actions in a wide variety of settings. *See, e.g.*, Hayagreeva Rao et al., *Fool's Gold: Social Proof in the Initiation and Abandonment of Coverage by Wall Street Analysts*, 46 ADMIN. SCI. Q. 502, 521 (2001) (finding herd behavior in research departments of investment banks).

Because this popular choice seems safe, it "pleases uninformed shareholders who assume it is correct, and produces no adverse reaction from a marketplace that cannot easily evaluate legal differences and so prefers the consensus choice."[78]

The decline in merit regulation by the states in recent years is consistent with a race to the bottom,[79] as is the trend, especially in Delaware, to give managers more and more leeway to freeze out minority shareholders without paying fair compensation in freezeout transactions.[80]

The most insightful way to look at state competition may be to focus on what states have *not* done. Most importantly, they have never required meaningful disclosure to shareholders.[81] Despite the indisputable benefits of corporate disclosure for the firm, shareholders, and potential shareholders, before the federal securities laws were adopted, the states' disclosure requirements for corporations were paltry, probably because of a fear that if

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[77] *See* Coffee, *Future as History*, *supra* note 5, at 703 (noting that companies may incorporate in a popular jurisdiction "for reasons that are simply based on its popularity, not the inherent superiority of its law"); Adam J. Hirsch, *Evolutionary Theories of Common Law Efficiency: Reasons for (Cognitive) Skepticism* 34–35 (Fla. St. Univ. Coll. of Law, Working Paper No. 129, 2004), *available at* http://ssrn.com/abstract=600041 (noting additional factors such as information cascades that can cause firms to select a body of law even though it is not the most efficient).

[78] Coffee, *Future as History*, *supra* note 5, at 703.

In a situation of uncertainty, decision-makers strongly prefer to conform to that which they perceive to be the most common position or the status quo. *See generally* Robert A. Prentice, *Teaching Ethics, Heuristics, and Biases*, 1 J. BUS. ETHICS EDUC. 57, 59–60 (2004) (noting how status quo bias and conformity bias [("social proof")] can impact decision makers).

[79] *See* James D. Cox, *Regulatory Duopoly in U.S. Securities Markets*, 99 COLUM. L. REV. 1200, 1243 (1999) (suggesting that the fact that an issuer denied a permit to sell securities in State *A* could move to State *B* prompts State *A* to suffer a weakening resolve to aggressively enforce disclosure regulations).

[80] *See* Jason M. Quintana, *Going Private Transactions: Delaware's Race to the Bottom*, 2004 COLUM. BUS. L. REV. 547, 598 (noting that "Delaware is leading the race to the bottom" in its going-private jurisprudence). *See also* Bradley R. Aronstam et al., *Delaware's Going-Private Dilemma: Fostering Protections for Minority Shareholders in the Wake of* Siliconix *and* Unocal Exploration, 58 BUS. LAW. 519, 557 (2003) (noting that current Delaware cases "leave minority shareholders with inadequate fairness protections in going private transactions").

[81] *See* Thompson & Sale, *supra* note 61, at 867 (noting that "[m]ost state corporation statutes impose few mandatory disclosure obligations"). Delaware, for example, does not require any information be delivered to shareholders except under traditional shareholder inspection statutes, and does not provide what information corporations should preserve for inspection. *Id.*

they required meaningful disclosure, corporations might move to other states that did not.[82]

Additionally, as Mark Roe has pointed out, among other things that most states have *not* done are: (a) remedy abuses in the solicitation of proxies, (b) allow meaningful access to shareholder lists, (c) prohibit bundling of shareholder proposals so that management could not package entrenchment proposals with special dividend proposals that shareholders were sure to support, (d) ban insider trading, (e) impose meaningful fiduciary duties upon officers and directors, (f) provide meaningful remedies for minority shareholders in going-private transactions, (g) require equal treatment of shareholders in takeovers, and (h) ban dual-class recapitalizations.[83] In all of these areas, federal regulation was required to advance shareholder interests and to impose meaningful accountability on corporate managers, because the states would not step up to the plate.[84] If state regulatory competition played any role in this process, it was to exert a downward influence.[85]

Simply put, Delaware has no meaningful competition from any other state and to the extent that some minor state competition exists, it pulls Delaware down and not up.[86] Overall, "Delaware's pro-managerial bias has

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[82] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 611 (2003) ("[T]he states generally required no information to be disseminated, seeing the annual election as sufficient to induce incumbents to give out information sua sponte—although in practice, little information was sent out.").

[83] *Id.* at 611–626.

[84] Before Sarbanes-Oxley outlawed loans from public companies to their top officers, in response to several egregious abuses, Delaware had "one of the most permissive statutes" allowing such loans. Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance* 87 (ECGI Finance Working Paper Series, Working Paper No. 52, 2004), *available at* http://ssrn.com/abstract=596101.

[85] Delaware does not, except in unusual circumstances, require any disclosure to shareholders, mandate independent directors, or provide for monitoring by independent accountants. Instead, "Delaware has abandoned most legal controls on the manager's duty of care, again leaving that to private ordering." Thompson & Sale, *supra* note 61, at 868.

[86] *See* ROGER LOWENSTEIN, ORIGINS OF THE CRASH: THE GREAT BUBBLE AND ITS UNDOING 87 (2004) (noting that "[i]n practice, Delaware, Nevada, and the rest competed to see which could write the most notoriously lenient rules . . ."); Subramanian, *Disappearing Delaware*, *supra* note 73, at 32 ("The trajectory of the Delaware effect further suggests that it cannot provide support for the 'race to the top' view of regulatory competition, as some commentators have argued, and may in fact provide support for the 'race to the bottom' view."); Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551, 603 (1987) (finding in evidence of investors' lack of reaction to Delaware court decisions regarding corporate law evidence "cast[ing] considerable doubt on

increased in tandem with the increase in its market power."[87] The body of corporate law enacted by Delaware simply does not track with predictions of race-to-the-top theory.[88]

The primary force preventing Delaware from being even more consistently pro-manager than it has been is federal regulatory competition from Congress and the SEC.[89] Since 1933, the federal government has generally played the "bad cop" regarding manager wrongdoing, reining in via disclosure requirements, insider trading bans, and fraud prohibitions, the abuses that have been enabled by consistently more pro-manager state corporate law.[90] A key reason why Delaware does from time to time raise its standards is a realistic fear that if it does not do so, the federal government will step in via congressional or SEC action.[91] Mark Roe has observed the strong correlation between a threat of federal preemption and Delaware's corporate law jurisprudence.[92] A prominent Delaware attorney admitted in 1988 that Delaware had to moderate its antitakeover law in order to avoid

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Winter's claim that investors' decisions concerning whether to buy the stock of Delaware or non-Delaware companies operate so as to preclude the development of unduly pro-manager systems of corporate law").

87 Barzuza, *supra* note 32, at 197.

88 Daniel J. H. Greenwood, *Democracy and Delaware: The Mysterious Race to the Bottom/Top*, 23 YALE L. & POL'Y REV. 381, 398–99 (2005).

89 Another factor that should not be ignored is the embarrassment that Delaware courts have felt for being known as the "management can do what it wants" jurisdiction, in an era in which everyone is painfully aware of management abuses in Enron, Global Crossing, Tyco, etc. *See* Amy Borrus, *Less Laissez-Faire in Delaware?*, BUS. WK., Mar. 22, 2004, at 80 (quoting Professor Charles M. Elson).

90 *See* Bratton & McCahery, *Equilibrium*, *supra* note 45, at 5–6.

91 *See* Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation* 36 (Columbia Law & Econ., Working Paper No. 259, 2004), *available at* http://ssrn.com/abstract=600709 (noting that "corporate governance issues that the federal government believes were not adequately handled by the states will likely find their way into securities regulation"); Marc Gunther, *Boards Beware!*, FORTUNE, Nov. 10, 2003, at 171 (noting that after Enron, if Delaware "was perceived to be doing a less-than-rigorous job of protecting shareholders, the federal government might take more responsibility for corporate law, thereby eroding Delaware's power"); Subramanian, *Bargaining*, *supra* note 54, at 681–82 (noting that, in every post-Sarbanes-Oxley case involving directors' fiduciary duties, the Delaware courts had ruled to protect shareholders, and observing that this trend "is unlikely to be coincidental"). As William Allen, former Delaware Chancery Court judge recently admitted, "[i]t would not be unreasonable to assume that the Delaware courts are responding to the Enron and WorldCom headlines and the intrusion, so to speak, of the federal government into the internal governance of corporations." Gunther, *supra*, at 177.

92 *See* Roe, *supra* note 82, at 645; Jones, *supra* note 23, at 663 ("There is reason to suspect that if the federal threat recedes, Delaware will revert to its more lax jurisprudence.").

federal preemption.[93] More recently, Delaware judges have openly discussed the path that Delaware law must take in the post-Enron era to avoid even more incursion upon state authority than Sarbanes-Oxley already represents.[94] Ultimately, a powerful SEC, which many regulatory competition advocates would like to eviscerate, stands as the key force preventing the race to the bottom from accelerating.[95]

A final point, of course, is that the 2002 Sarbanes-Oxley Act (SOX)[96] completely changes the debate by federalizing much of corporate law. It solidifies the argument that Roe had already made that state regulatory competition does not explain American corporate law; rather "the fundamental inter-governmental relationship in making American corporate law is that between Congress and Delaware, not that between Delaware and other states."[97]

Sarbanes-Oxley illustrates what Bratton and McCahery describe as a comfortable equilibrium that has evolved over the past century.[98] In this equilibrium, "[w]hen a problem with national market implications arises, all parties expect the national system to address it."[99] Because increasingly our economic problems do have national implications, all parties are accustomed to a larger federal role. They recognize its necessity and they welcome it. Therefore, the debate for the immediate future should be whether specific SOX provisions produced good or ill, not whether the Feds should have ignored the Enron scandal and left corporation law to imaginary state regulatory competition.

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[93] Roe, *supra* note 82, at 605 (quoting A. Gilchrist Sparks III, chair of the Delaware Bar Association Corporate Law Council).

[94] *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* 24 (NYU Ctr. for Law & Bus. Research, Working Paper No. 03–01; Univ. of Pa. Inst. for Law & Econ. Research, Working Paper No. 03–03, 2003), *available at* http://ssrn.com/abstract=367720.

[95] *See* Griffith, *supra* note 59, at 66–67 (noting that scandals bring the threat of federal intervention, which can cause Delaware judges to increase management accountability, but when federal intervention is not a threat, corporate interest groups usually secure less judicial intervention and more deference to boards).

[96] Sarbanes Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745.

[97] Mark J. Roe, *Delaware's Politics* 40 (Nov. 22, 2004) (unpublished working paper), *available at* http://www.law.uchicago.edu/Lawecon/workshop-papers/roe.pdf.

[98] Bratton & McCahery, *Equilibrium*, *supra* note 45, at 1.

[99] *Id.* at 12.

III. STATE SECURITIES LAW COMPETITION

Advocates for race-to-the-top state corporate law competition have naturally taken the next logical step in their belief system by recommending that America's strong SEC model be replaced by state securities law competition.[100] They argue for a "market approach to securities regulation, . . . [which] takes as its paradigm the successful experience of the U.S. states in corporate law, in which the fifty states and the District of Columbia compete for the business of corporate charters."[101]

A. *No Meaningful State Securities Law Competition Exists*

If state competition for corporate charters via corporate regulation is largely a myth, then state competition for securities law is likely to be equally fanciful. State legislatures have long been the dominant players in corporate law, yet they do not meaningfully compete there. How much less likely is it that they will compete in the realm of securities regulation where they have less experience and interest, where they have been only marginal players for at least seventy years,[102] and where there is no obvious motive to

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[100] The regulatory competition theory has been extended from corporation law to other areas as well, including (a) environmental law, *see, e.g.*, Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1210 (1992); (b) bankruptcy law, *see, e.g.*, David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 474 (1994); and (c) family law, *see, e.g.*, Jennifer Gerarda Brown, *Competitive Federalism and the Legislative Incentives to Recognize Same-Sex Marriage*, 68 S. CAL. L. REV. 745 (1995).

In at least some of these areas, the evidence seems to indicate strongly that the race is toward the bottom. *See, e.g.*, WILLIAM K. BLACK, THE BEST WAY TO ROB A BANK IS TO OWN ONE: HOW CORPORATE EXECUTIVES AND POLITICIANS LOOTED THE S&L INDUSTRY 35, 225 (2005) (demonstrating that during the Savings and Loan debacle of the 1980s, there was a race to the bottom among states regulating S&Ls and that most of the worst frauds were clustered in states that had deregulated the most because they attracted the most dishonest operators); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1114 (2000) ("[I]f individual jurisdictions are free to compete for trust business by offering attractive packages of trust law provisions, many of them will have incentives to adopt inefficient, externality-generating trust law rules.").

[101] Romano, *Empowering Investors*, *supra* note 48, at 2361. Professor Romano also extends this theoretical argument to the *international* securities arena, as evaluated in the next section.

[102] *See* ROMANO, ADVANTAGE, *supra* note 35, at 2 ("[F]ederal securities law has occupied the securities field and . . . state law development has been marginal.").

induce foreign corporations to choose their body of securities law? Why, pray tell, would Texas, for example, desire that a California corporation choose Texas law to govern transactions in its securities?

Even if Texas did have such a desire, its securities board had a budget of only $3.45 million in 1999.[103] This amount would be unlikely to enable the Texas State Board of Securities to promulgate innovative rules and regulations, to investigate large-scale frauds, or to effectively prosecute schemes spread across state and national borders on anything but a sporadic basis. The SEC's large, coordinated antifraud enforcement organization is necessarily more efficient and effective than those of the fifty states.[104]

And consider this Catch-22. If under a hypothetical system of state regulatory competition, firms often changed bodies of securities law, then investors would never be able to rely upon on any rules. They might discount the shares of a company to account for a particular regulatory regime, only to have the company switch to a much less efficient regime.[105]

More likely, because companies seldom reincorporate, in a regime of issuer choice, firms will change securities laws only infrequently. Therefore, states would not attract meaningful numbers of companies by developing innovative or efficient law. If companies change securities regimes only infrequently, then they will continue to live under a regulatory monopolist of the type that regulatory competition advocates decry the SEC for being. Is it reasonable to believe that the securities agencies of Oklahoma or Arkansas will make fewer regulatory mistakes than the SEC?[106]

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[103] TEXAS STATE SECURITIES BOARD, SELF-EVALUATION REPORT 13 (1999), *available at* http://www.sunset.state.tx.us/77threports/ssbSER.pdf.

[104] *See* Bebchuk & Hamdani, *supra* note 23, at 609–10 ("[A] federal regulator would have, and be willing to devote, more resources for developing and implementing legal rules that would enhance shareholder wealth in publicly traded companies.").

[105] Greenwood, *supra* note 88, at 401 ("[I]f managers can change the state of incorporation pretty much at will, we are back in a market for lemons.").

[106] Joel P. Trachtman, *Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation* 22 (Dec. 9, 1999) (unpublished working paper), *available at* http://ssrn.com/abstract=193688 ("Romano fails to muster any evidence to support her claim that competing regulators would make fewer mistakes than a monopolistic regulator.").. Having all of the states (and nations in other regulatory competition models) working on securities law provides lots more monkeys banging on lots more typewriters, but whether it realistically moves the system closer to production of the next Hamlet is questionable.

B. *Race to the Bottom*

Because there is no current state regulatory competition to provide new securities law, there is little independent evidence regarding whether, if such a race developed, it would be a race to the top or a race to the bottom. The same evidence and arguments that apply to state corporate law competition would seem to apply equally here, though, and therefore suggest that such a contest would be leisurely and southerly.

Because there is little specific evidence of the directionality of this nonexistent race, consider this thought experiment. If we are really serious about stimulating regulatory competition for securities law, consider creating forty-nine more SECs. The current SEC will be known as SEC1. The others will be known as SEC2 through SEC50. Each of the fifty agencies will have its own head and its own staff. Each will be charged with working independently to come up with the best possible set of securities regulations. Companies can opt into the rules and regulations of any of the fifty SECs. To give the fifty SECs' employees an incentive to be inventive, creative, and perspicacious, a twenty-five percent salary bonus will be granted at year's end to the employees of the SEC attracting the most firms.

Because the federal government has more resources,[107] both in terms of money and in terms of access to experienced personnel,[108] its fifty agencies should be able to perform better than the folks in Kansas and South Dakota who have few fiscal resources[109] and relatively few employees with sophisticated securities experience. The fifty agencies can also share a common enforcement mechanism which should be more efficient and cost effective than the fifty different enforcement arms that the states will have to utilize.

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[107] Bebchuk & Hamdani, *supra* note 23, at 609–10 ("The resources used [for developing and implementing legal rules] are an order of magnitude larger than those devoted by states for such purposes.").

[108] Although I would choose differently, I take it as a given that most experienced securities attorneys would rather live in the Washington D.C. area than in Topeka or Pierre.

[109] THE GOVERNOR'S BUDGET REPORT VOLUME 1: DESCRIPTIONS AND BUDGET SCHEDULES, FISCAL YEAR 2006, at 59 (2005), *available at* http://da.state.ks.us/budget/publications/FY2006/FY2006_GBR--Volume_1.pdf (indicating that the budget for the Office of the Kansas Securities Commissioner in 2006 was $2.48 million).

Although this plan is arguably superior to state competition, it is obviously goofy.[110] Rather than try it, or state competition, a better plan is to work to ensure that the SEC is doing the best job possible.[111]

Eliot Spitzer notwithstanding, any suggestions that a national agency is not needed to prevent securities fraud and that the states can manage just fine on their own,[112] are dubious. No state securities regulator would support that notion, any more than state attorneys general would suggest that the FBI be disbanded. Supporters of regulatory competition have attempted to argue that the states were doing just fine in policing securities fraud before the federal acts were passed, noting that Benston found scant evidence of fraudulent financial statements before the 1934 Act.[113] However, Benston's conclusion has been thoroughly debunked by Seligman, who has noted:

> Benston's suggestion that there was little securities fraud before 1934 was ludicrous. His "search of the available literature" apparently did not lead him to read of a single enforcement action brought by any of the forty-seven states that enacted blue sky securities regulation laws between 1911 and 1933. Yet in the year 1932, the State of New York alone secured injunctions against 1522 persons and firms and instituted 146 criminal proceedings.[114]

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[110] It is no sillier than taking regulatory competition to its logical, *reductio ad absurdum*, conclusion of authorizing each *county* in every state to offer a corporate law or securities law regime. With that many more monkeys pounding on that many more typewriters, who knows what innovations might arise?

[111] Although regulatory competition between enforcement agencies, such as Eliot Spitzer's New York Attorney General's office and the SEC can occasionally spur more effective enforcement, such competition is more often likely to lead to wasted resources and inconsistent enforcement. *See* Cary Coglianese et al., *The Role of Government in Corporate Governance* 21 (Harvard Univ. John F. Kennedy Sch. of Gov't, Working Paper No. RWP04–045, 2004), *available at* http://ssrn.com/abstract=613421.

[112] ROMANO, ADVANTAGE, *supra* note 35, at 43.

[113] *Id.* at 44.

[114] JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 564–65 (rev. ed. 1995); *see also* Robert L. Smitley, *Checkmating the Stock Swindler*, 22 MAG. OF WALL ST., Aug. 3, 1918, at 626 (noting "wildcat enterprises" that are "sheer swindles" costing investors $200 million each year); Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C. J. INT'L L. & COM. REG. 725, 735 (2003) (noting that after the Panic of 1907, "[t]he Pujo Committee also discovered numerous abuses in the securities markets, including insider trading"); Richard D. Wyckoff, *The Remedy That Will End the Bucket Shop Evil*, 29 MAG. OF WALL ST., JAN. 7, 1922, at 301 (noting widespread problems of bucket shops that were costing the public "millions" and the NYSE's "half-hearted attempts" to stop them); *Eliminating the Financial Fakirs*, 21 MAG. OF WALL ST., Mar. 30, 1918, at 924 (noting the indictment of the principals of several hundred stock gambling corporations that had fleeced investors

Market manipulation[115] and conflicts of interest (situations where insiders could benefit themselves at the expense of minority shareholders) were widespread in corporations in the early twentieth century.[116]

IV. INTERNATIONAL SECURITIES LAW COMPETITION

Advocates of regulatory competition have extended the logic of state securities law competition to the international realm by proposing multinational securities law competition.[117] Why should a U.S. company not be able to choose to be governed by the securities laws of France? Or Uruguay? Or Botswana? As noted earlier, Professor Romano and Professors Choi and Guzman envision companies being able to choose to be governed by the laws of countries that provide for much, little, or no disclosure; much, little, or no fraud protection; and many, few, or no corporate governance rules. Whereas Romano generally posits a sprint to the top, Choi and Guzman admit that some issuers may choose regimes of little or no fraud protection for investors, but suggest that investors, being "rational and

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out of $10 million); *Are the Bucket Shops Coming Back?*, 34 MAG. OF WALL ST., June 21, 1924, at 259 (noting that the New York District Attorney had secured forty-seven convictions in bucket shop cases and had nearly as many cases still pending).

115 Paul Mahoney has done an empirical study purportedly demonstrating that stock pools did not affect trading in the stock markets before the '34 Act was passed. *See* Paul G. Mahoney, *The Stock Pools and the Securities Exchange Act*, 51 J. FIN. ECON. 343, 367 (1999). This may be true, but would come as quite a surprise to the Wall Street professionals who repeatedly observed the impact of such pools at the time. *See generally*, Scribner Browne, *How to Detect Pool Operations in Stocks: Practical Hints by an Experienced Trader*, 19 MAG. OF WALL ST., Oct. 14, 1916, at 4 (describing how pools work and giving examples); Weldon Chase, *A Pool That Failed*, 34 MAG. OF WALL ST., Sept. 27, 1924, at 846–47 (giving example of a major pool manipulation that raised shares of Colorado Fuel & Iron common stock from $30/share to $50/share in short order, but ultimately failed); John Durand, *The Principles of Manipulation (pt. 2)*, 38 MAG. OF WALL ST., June 19, 1926, at 334 (explaining how pools and others manipulate the stock market); Richard D. Wyckoff, *The Insiders—The Pools—and The Public*, 36 MAG. OF WALL ST., Sept. 12, 1925, at 883–84 (noting that "[o]n today's ticker tape there are hundreds of footmarks of pools, manipulators, insiders, and victims . . ."); *Points on Market Manipulation*, 34 MAG. OF WALL ST., June 7, 1924, at 175 (noting "instances of gross and unjustifiable manipulation of securities" by pool operators and others and giving examples).

116 Naomi R. Lamoreaux & Jean-Laurent Rosenthal, *Corporate Governance and the Plight of Minority Shareholders in the United States Before the Great Depression* (Nat'l Bureau of Econ. Research (NBER), Working Paper No. W10900, 2004), *available at* http://ssrn.com/abstract=618582.

117 Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES LAW 387, 388 (2001); Romano, *Empowering Investors*, *supra* note 48, at 2418–24; Choi & Guzman, *Choice*, *infra* note 249.

informed," will simply discount what they are willing to pay for those shares.[118]

A. *There Is No Meaningful International Competition*

Because there is no evidence that states compete in a meaningful manner by passing innovative corporate codes or innovative securities laws, it should not be surprising that the evidence of international competition in securities law is similarly weak.[119] European nations, for example, do not compete in any meaningful way for incorporations, and all indications are that they are unlikely to begin doing so any time soon.[120] There seems even less reason for them to compete to provide securities regulation for foreign firms, because there is no obvious way for them to earn significant amounts of revenue doing so.

The situation regarding incorporations seems unlikely to change significantly. If incorporations would generate so little income that they provide no incentive for Montana or Wyoming to attempt to emulate Delaware, it is difficult to see an incentive for Germany or Japan or even Zimbabwe to do so. Indeed, Professor Tung ran the numbers and found that the entire amount of securities fees paid worldwide would scarcely catch the attention of the governments of the nations that can realistically provide the machinery for meaningful securities regulation.[121] Furthermore, it is so easy for German and Japanese investors to invest in American companies from their home countries that no American companies need incorporate abroad to raise funds.

Choice of law rules might stymie any such competition even if countries were, against all reason, interested in competing. In the U.S., the internal affairs doctrine is a choice of law rule that allows corporations to locate their businesses anywhere, but have their internal affairs governed by the law of a

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[118] Stephen Choi, *Promoting Issuer Choice in Securities Regulation*, 41 VA. J. INT'L L. 815, 816 (2001) [hereinafter Choi, *Issuer Choice*].

[119] There may be some international competition for incorporations, but it is apparently even a lesser competition than that among the states. *See* Bratton & McCahery, *New Economics*, *supra* note 8, at 266.

[120] Ehud Kamar, *Beyond Competition for Incorporations* 4–5 (NYU Law & Econ., Research Paper No. 05–01; Univ. of S. Cal. Legal Studies, Research Paper No. 05–13; ECGI Law Working Paper Series, Working Paper No. 42, 2005), *available at* http://ssrn.com/abstract=720121.

[121] Frederick Tung, *Lost in Translation: From U.S. Corporate Charter Competition to Issuer Choice in International Securities Regulation*, 39 GA. L. REV. 525, 590–91 (2005) [hereinafter Tung, *Translation*].

different state by incorporating in that other state.[122] In Europe and elsewhere, however, the rule has traditionally been "that the law of the corporation's main place of operations or business governs (the *siège social* [or 'real seat'] rule)."[123] This rule makes it extremely unlikely that countries around the world, even if they wished to create an international competitive system of corporate law or securities regulation, could do so.[124] Even competition supporters admit that it would not be possible to create such a competitive regime unless nations agree to alter completely their current approach to securities regulation.[125] This would require negotiation of treaties[126] of a type that have not been considered, and are unlikely to be. Tung has observed that the "very incentives that would theoretically drive national regulators to compete, if an international market for regulation existed, would also make them unwilling to supply the choice of law rules essential to creating that market in the first place, at least in important jurisdictions."[127]

Recently, three European Court of Justice (ECJ) decisions held that the real seat rule, as aggressively applied in the past by EU member states, is incompatible with the Freedom of Establishment provision of the EC Treaty.[128] These new decisions are unlikely to give rise to competitive

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122 Edgar v. Mite Corp., 457 U.S. 624, 645 (1982). The Court notes:

> The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs—matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders—because otherwise a corporation could be faced with conflicting demands.

Id.

123 Lawrence A. Cunningham, *From Convergence to Comity in Corporate Law: Lessons from the Inauspicious Case of SOX* 14 (Boston Coll. Law Sch., Pub. Law & Legal Research Paper Series, Paper No. 24, 2003), *available at* http://ssrn.com/abstract=462142.

124 Tung, *Translation*, *supra* note 121, at 561–81. Tung notes that without an international consenus that each nation should honor private choice in securities regulation, as American states do in the corporate law realm, jurisdictional competition could not effectively occur. *Id.* at 542.

125 ROMANO, ADVANTAGE, *supra* note 35, at 150.

126 *Id.* (noting that international securities regulatory competition could come about only if "effectuated by a treaty or other executive agreement approved at a higher governmental level than securities agencies").

127 Tung, *Monopolists*, *supra* note 5, at 1369.

128 *See* Case C–212/97, Centros Ltd. v. Erhvers-og Selskabsstyrelsen, 1999 E.C.R. I–1459, 2 C.M.L.R. 551 (1999); Case C–208/00, Uberseering BV v. Nordic Constr. Co.

securities regulation, however, for the roadblocks to jurisdictional competition just within Europe (not to mention with nations from other continents) remain formidable.[129] EU nations have evinced no interest in beginning such a competition.

Even in the unlikely event that governments across the globe changed their current practices and became interested in competing to provide securities regulation, most corporations would do just as they do in the U.S.—stay home. The reason is that their managers and attorneys, the driving force behind making such a decision, would be reluctant to "forsake significant learning and coordination benefits that have accrued with territorial regulation."[130] Given that investors prefer local stocks,[131] that the price of cross-listed securities is typically dominated by activity on the home country exchange,[132] and that local investors generally enjoy informational advantages over foreign investors, the "hometown effect . . . guarantees the regulatory monopolies that issuer choice proponents decry."[133]

B. *Race to the Bottom*

With no significant international competition for incorporations or for provisions of securities laws to study, conclusions must be tentative about the direction such a race would take if it were to occur. However, just as the little competition there is for incorporations in America tends toward the bottom rather than the top, the same would likely happen if significant competition ever came about in the international sphere. American companies reincorporate in Bermuda to pay less tax, not more. Gambling operations

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Baumanangement GmbH (NCC), 2002 E.C.R. I–9919; Case C–167/01, Kamer van Koophandel en Farbrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I–10155.

[129] Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L L. 477, 506–07 (2004). Although Dammann is a proponent of intra-European regulatory competition, and remains optimistic that new EC rules could change things, the picture he paints is discouraging, with major legal and practical barriers still in place. *Id.* Dammann is addressing corporate law competition, but the specified roadblocks would apply equally to securities law competition. *See also* Christian Kirchner et al., *Regulatory Competition in EU Corporate Law after* Inspire Art*: Unbundling Delaware's Product for Europe* 8 (Univ. of Ill. Coll. of Law, Law & Econ. Working Paper No. LE04–001, 2004), *available at* http://ssrn.com/abstract=617681 (noting that "the seat theory may continue its de facto dominance").

[130] Tung, *Translation*, *supra* note 121, at 536.

[131] *See* Karen K. Lewis, *Trying to Explain Home Bias in Equities and Consumption*, 37 J. ECON. LITERATURE 571, 572 (1999) (explaining "home bias puzzle").

[132] *See* Kenneth A. Froot & Emil M. Dabora, *How Are Stock Prices Affected by the Location of Trade?*, 53 J. FIN. ECON. 189, 190–91 (1999) (finding this phenomenon).

[133] Tung, *Translation*, *supra* note 121, at 565.

incorporate in the Bahamas to avoid regulation, not to embrace it. Companies that choose to play the regulatory competition game might also have less than honorable intentions.

As noted earlier, only small and very poor countries could be interested in the revenue generated by such a system, and they would lack the capacity to provide the legal system, expertise, and other elements necessary to for meaningful regulation.[134] If they actively entered a race to provide regulatory alternatives, their most realistic avenue for doing so would be as a haven for crooks.

Race-to-the-top logic is supported by the substantial evidence that countries with higher disclosure requirements and more stringent corporate governance rules provide an environment in which companies can raise more money faster and cheaper.[135] Therefore, the theory goes, companies should voluntarily flock to those countries which require more disclosure and better governance as a way of "bonding" for investors. This should, in turn, prompt nations to raise their standards to attract more and more companies. Unfortunately, as with state corporate competition, reality does not accord with theory.

For example, recently, firms from Eastern Europe flocked to Delaware to form limited liability corporations under Delaware law. Were they doing it to signal to shareholders that they were adopting standards to protect their best interests? No, they were doing it because secrecy provisions in Delaware laws allowed them to set up shell corporations as a means of laundering money. These were criminal enterprises from Russia, the Ukraine, and elsewhere doing what criminal enterprises do when regulation is lax.[136] Ireland recently had a similar race-to-the-bottom experience when it allowed foreign companies to establish IRNRs (Irish nonresident companies). They used those entities "to funnel hot money into tax-free havens and to hide the identities of some investors."[137] These examples are not encouraging for the future of international securities regulatory competition.

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[134] Tung, *Translation*, *supra* note 121, at 598–616.

[135] *See* Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1495–99 (citing numerous studies).

[136] *See* Glenn R. Simpson, *Money-Laundering Investigators Flock to Delaware*, WALL. ST. J., Sept. 30, 2004, at A4.

[137] *See* Nick Webb, *Mexican Tycoon's Insider Dealing Probe Leads Back to Ireland*, SUNDAY INDEP. (Ireland), Feb. 29, 2004.

IV. DOMESTIC STOCK EXCHANGE COMPETITION FOR LISTINGS

A. *Existence of Competition*

Stock markets do have a clear incentive to compete for listings. Unlike most states (which seem to be largely indifferent to attracting incorporations by out-of-state companies) and most nations (which seem similarly indifferent to the opportunity to provide securities law regimes to foreign firms), exchanges profit from trading volume and do desire to take listings away from other exchanges, both domestic and foreign. Clearly the NYSE wishes to take listings away from NASD, and vice versa. Both battle electronic exchanges for market share. Competition is constrained by SEC regulation, which shapes the possibilities for all of the market players.

B. *Race to the Bottom*

Absent SEC regulation, would the competition among exchanges create a race toward the top or a race toward the bottom? Professor Mahoney argues that it would be a race to the top because "[s]elf-interested stock exchange members will produce rules that investors want for the same reasons that self-interested bakers produce the kind of bread that consumers want."[138] Pritchard makes a similar argument: more fraud means less liquidity, less liquidity means fewer trading commissions for broker-dealers, broker-dealers hold a property right in exchanges, and, therefore, broker-dealers should be incentivized to "push exchanges to enforce vigorously prohibitions against fraud on the market."[139]

Initially, it is not intuitively obvious why the NYSE, which cannot protect itself from being ripped off to the tune of $180 million by its CEO,[140] should have the primary responsibility for policing fraud in the securities markets. Frankly, the picture of entrepreneurial exchanges developing new and efficient listing requirements that is painted by regulatory competition advocates does not closely resemble the dominant exchanges' actual

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[138] Paul Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1459 (1997).

[139] Adam C. Pritchard, *Markets as Monitors: A Proposal to Replace Class Actions with Exchanges as Securities Fraud Enforcers*, 85 VA. L. REV. 925, 929 (1999) [hereinafter Pritchard, *Markets as Monitors*].

[140] *See NYSE Chief's Pay 'Out of Whack,'* FIN. TIMES, Feb. 3, 2005, at 16 (noting that the Webb Report on former CEO Richard Grasso's pay "paints a picture of a board of directors . . . that was not fully aware of what it had agreed to pay its chairman, or why").

practices. As Choi and Fisch have pointed out, the NYSE "is controlled by member firms with a financial interest in retaining the existing structure."[141] Because securities exchanges have traditionally operated as membership-driven organizations, they have generally "behaved more like sluggish monopolies than dynamic entrepreneurs."[142]

Furthermore, the assumption of substantial alignment between the interests of the exchange and of the investors that they are to protect is faulty on several levels. First, if, as is often the case, there is a conflict of interest between the exchange's members and the listing company, the listing company will often be sacrificed. An example is NYSE Rule 500, which, until at least 1997, made it extremely difficult for a company to delist from the exchange and go elsewhere.[143]

Second, if, as is even more often the case, there is a conflict of interest between the listing company's investors and its managers, exchanges know that it is the managers who make the listing decision, so they will accommodate the managers, who may want less monitoring more than the investors want better governance.

Third, if, as frequently happens, the issuer and its managers have no particular horse in the race, but there is a conflict of interest between the NYSE members and investors, the NYSE will too often favor its members.[144]

A quick history of the NYSE makes the point that, in terms of disclosure requirements, anti-fraud enforcement, and other issues important to investors, exchanges are not even up to the task of self-regulation, let alone the task of regulating the general securities markets.

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[141] *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries*, 113 YALE L.J. 269, 303 n.159 (2003) (suggesting that shareholders of NYSE companies who complain about methods of counting votes in the current proxy system are not likely to find a sympathetic ear at the exchange).

[142] Coffee, *Racing Towards the Top*, *supra* note 5, at 1800 (noting that this is beginning to change as various exchanges around the world demutualize).

[143] Laura Nyantung Beny, *U.S. Secondary Stock Markets: A Survey of Current Regulatory and Structural Issues and a Reform Proposal to Enhance Competition*, 2002 COLUM. BUS. L. REV. 399, 463 n. 302 (explaining Rule 500).

[144] Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1435 (noting several facets of this misalignment); *see also* JOHN S. GORDON, THE GREAT GAME: THE EMERGENCE OF WALL STREET AS A WORLD POWER, 1653–2000, at 213 (1999) ("It is a law of human nature that, absent outside pressure, organizations tend to evolve in ways that favor their elites . . . [F]ew better examples of this phenomenon exist than the New York Stock Exchange in the 1920s.").

1. *Before 1933*

Some have claimed that before federal regulation, exchanges attracted listing companies by requiring them to disclose information that investors would wish to know and by effectively fighting fraud by issuers that might damage shareholders. This is an optimistic reading of history. Full disclosure for shareholders did not exist before the 1933 and 1934 Acts were passed, and prospectuses used at that time "were 'little more than notices.'"[145]

Only under pressure from the government did the NYSE slowly adopt disclosure requirements,[146] and it generally failed to enforce them in any vigorous way. As *The Magazine of Wall Street* reported at the time, "the [NYSE] has permitted, or has been under the necessity of permitting, many 'listed' companies to continue on their way without any penalties being imposed because of variously unsatisfactory financial statements."[147] The NYSE's only meaningful penalty was delisting and, naturally, it shied away from the attendant decrease in revenue that would follow if it actually enforced its own disclosure rules. For that reason, although railroads and

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[145] Jerry W. Markham, *Accountants Make Miserable Policemen: Rethinking the Federal Securities Laws*, 28 N.C.J. INT'L L. & COM. REG. 725, 733–34 (2003) (quoting United States v. Morgan, 118 F. Supp. 621, 639 (S.D.N.Y. 1953)).

[146] *See* Allen Ferrell, *The Case for Mandatory Disclosure in Securities Regulation Around the World* 28–29 (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 492, 2004), *available at* http://ssrn.com/abstract=631221 (noting that the NYSE resisted imposing any disclosure requirements, but finally commenced in a modest way in 1910 under "intense governmental pressure").

[147] *Corporation Reports That Do Not Report!*, 34 MAG. OF WALL ST., May 10, 1924, at 18. And these were not minor defects, the article noted:

> The "defects" (for lack of a better term) contained in the reporting methods of companies such as those enumerated include "disguising" earnings, by reason of unexplained write-offs; "concealing" earnings, by failing to divulge the results obtained by important subsidiaries; "distorting" earnings, particularly in quarterly reports and by failing to make allowances in such reports for necessary reserves to be written off inevitably, sooner or later; "inadequately describing earnings" by publishing incomplete Income Accounts.

Id.; *see also* Matthew Josephson, *Infrequent Corporation Reports Keep Investors in Dark*, 36 MAG. OF WALL ST., June 20, 1925, at 303 (noting that thirty percent of the NYSE-listed companies were exempt from the exchange's disclosure requirements in any event and that, among the other companies, "[t]here are too many instances in the present market of important news being held up until accumulation by insiders is complete"); *The Time Has Come for Corporations to Recognize the Rights of Investors in the Matter of Financial Reports!*, 33 MAG. OF WALL ST., March 29, 1924, at 932 (noting that, despite NYSE listing requirements, "all too great a proportion issue either *too few* reports or *too inadequate* reports or *reports that are misleading*").

utilities were required by government regulators to make regular reports of their financial condition, "many well-known companies maintain the utmost secrecy, either as a matter of tradition or on the grounds of competition."[148]

Additionally, before there was an SEC, the NYSE was often rife with fraud.[149] It and other exchanges were at the "epicenter of the manipulative and speculative activity that led to the Crash of 1929,"[150] and even after the crash the NYSE refused to enact any reform measures of its own, forcing a recalcitrant President Hoover to instigate a Senate investigation.[151]

2. *1933–2000*

Supporters of a much broader and more important role for exchanges in market regulation admit that exchanges have no incentive to stop manipulation because manipulation usually inflates trading volume and increases profits.[152] They claim, on the other hand, that exchanges do have a motive to prevent fraud which would diminish trading. But there is also evidence that they simply have the motive to hide such frauds as long as possible.[153] Indeed, the very "efficacy of self-regulation was called into

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[148] Josephson, *supra* note 147, at 303 (quoting NYSE economist Edward Meeker).

[149] *See* VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA 254 (1970) (noting that during the 1920s, there "was a marked decline in [investment banking] judgment and ethics and unscrupulous exploitation of public gullibility and avarice"); GORDON, *supra* note 144, at 215 (noting that in light of pools, wash sales, bear raids, and the like, the NYSE "was, at least for the quick-witted and financially courageous, a license to steal. Whom they were stealing from in general, of course, was the investing public at large").

[150] Onnig Hatchig Dombalagian, *Demythologizing the Stock Exchange: Reconciling Self-Regulation and the National Market System*, 39 U. RICH. L. REV. 1069, 1074 (2005).

[151] Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909, 923 (1994).

[152] Pritchard, *Markets as Monitors*, *supra* note 139, at 1003. *See also* Stephen C. Pirrong, *The Self-Regulation of Commodity Exchanges: The Case of Market Manipulation*, 38 J.L. & ECON. 141, 141 (1995) ("An examination of the history of self-regulation at 10 exchanges [including the NYSE] prior to the passage of laws proscribing manipulation shows that they took few, if any, measures to curb manipulation."); Stephen C. Pirrong, *The Efficient Scope of Private Transactions-Cost-Reducing Institutions: The Successes and Failures of Commodity Exchanges*, 24 J. LEGAL STUD. 229, 255 (1995) (finding that exchanges often do not adopt optimal rules and that government intervention can sometimes improve market efficiency).

[153] *See* Marcel Kahan, *Some Problems with Stock Exchange-Based Securities Regulation*, 83 VA. L. REV. 1509, 1518 (1997) ("[T]o the extent that an exchange believes that, absent policing, certain violations are likely to remain undiscovered, its incentives to engage in such policing are substantially reduced."); *see also* John C. Coffee, Jr., *Privatization and Corporate Governance: The Lessons from Securities Market Failure*,

question by stock market abuses reported in the 1963 SEC Special Study. . . ."[154] Unsurprisingly given the incentives, the NYSE has long earned a reputation of being reluctant to punish fraud among its members.[155]

NYSE proponents admit that many have criticized the NYSE for maintaining fixed commissions at the expense of investors,[156] but maintain that when the SEC passed rules to prohibit fixed commissions in 1975, this was essentially a *fait accompli* because of decisions already made by the Exchange.[157] However, the historical record indicates "that without a more assertive SEC [which itself arrived belatedly], the New York Stock Exchange was unwilling to design a commission-rate structure related to transaction costs and that market forces alone were unable to evolve" competitive brokerage rates.[158]

Even after September 11, 1973, when the SEC announced that it would end fixed commissions at the NYSE by May 1, 1975 if the NYSE did not do so itself, the NYSE "steadfastly opposed" the SEC's decision.[159] The NYSE's board of governors passed a resolution opposing abolition of fixed commissions unless the SEC shielded it from competition from third-market

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25 J. CORP. L. 1, 32 (1999) ("[Because exchanges] profit on trading volume, and they compete to list companies, they will not wish to delist an actively traded company, even when it misbehaves badly. Similarly, their incentives to take enforcement action against powerful broker-dealers also may be suboptimal.").

[154] Roberta S. Karmel, *Turning Seats Into Shares: Causes and Implications of Demutualization of Stock and Futures Exchanges*, 53 HASTINGS L.J. 367, 401 (2002) (citing SEC, REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95,. pt. 4 (1st Sess. 1963)) [hereinafter Karmel, *Demutualization*].

[155] John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 YALE L.J. 1, 68 n.254 (2001) (noting that before the SEC came into existence, "the NYSE seldom, if ever, enforced its own disciplinary rules"); SELIGMAN, *supra* note 114, at 11 (noting NYSE's reluctance to answer FBI Director Hoover's call to take action against pool operators and bear raiders in 1932); John E. Tracy & Alfred B. MacChesney, *The Securities Exchange Act of 1934*, 32 MICH. L. REV. 1025, 1034–35 (1934) (noting that the Hughes Commission in 1907 had "chided the New York Stock Exchange for its spirit of conservative camaraderie that made members lax in punishing culpable fellow-members, with the result that punishment, though swift, was only meted out after the horse, figuratively speaking, had been stolen").

[156] Pritchard, *Markets as Monitors*, *supra* note 139, at 1011–12.

[157] *Id.* at 1012; *see also* Mahoney, *The Exchange as Regulator*, *supra* note 138, at 1494–95 (making the same point).

[158] SELIGMAN, *supra* note 114, at 440.

[159] *Id.* at 482; *see also* Roberta S. Karmel, *The Future of Corporate Governance Listing Requirements*, 54 SMU L. REV. 325, 351 (2001) [hereinafter Karmel, *Future*] (noting the "determined efforts of the New York Stock Exchange in the 1963–1975 period to retain fixed commission rates").

trading, its chairman threatened suit against the SEC, its lobbyists bottled up securities bills in Congress because they contained provisions unfixing commissions, and its witnesses who testified in front of Congress predicted pretty much the end of life as we know it if fixed commissions were banned.[160] To make this out as an NYSE initiative misreads the evidence.

Several years ago, Professor Jeffrey Gordon argued that companies would list on the New York Stock Exchange (rather than AMEX and NASDAQ) because of its tougher listing requirements, particularly its one-share, one-vote listing rule.[161] His notion was that by committing to this higher listing standard, firms would "bond a promise" to investors who would be so impressed that they would pay more for the issuers' stock. Unfortunately, when push came to shove, the weakness of exchanges as regulators again was highlighted. General Motors wished to eliminate its one-share, one-vote structure[162] and the NYSE was hardly in a position to delist such a prominent company.[163] The NYSE did not wish to lose this company to its competitor exchanges.[164] Investor protection gave way to manager preference as the NYSE asked the SEC for permission to scrap its single-class common stock rule. Only later, after five years of active prodding by the SEC, did "the national markets . . . agree on a rule that protected shareholder interests."[165]

In a similar vein, in the early 1990s, in an attempt to gain more foreign listings, the NYSE urged that "world class" companies be exempted from all

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160 SELIGMAN, *supra* note 114, at 83.

161 Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 3, 66–68 (1988).

162 The NYSE had adopted the rule in the face of political pressure stirred up by a Harvard professor, William Z. Ripley, who met with President Coolidge about the matter. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Role of Law in the Separation of Ownership and Control*, 111 YALE L.J. 1, 38 (2001) (noting that Ripley's speech had received "wide press coverage" and that President Coolidge was "apparently sympathetic" to Ripley's concerns).

163 Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 558 (1990) (citing Securities Exchange Act Release No. 24,623, 52 Fed. Reg. 23,665 (June 24, 1987)) (giving a history of the one share, one vote rule).

164 Karmel, *Future*, *supra* note 159, at 345. *See also* Rock, *infra* note 184, at 699 (noting that the one-share, one-vote controversy "provides a cautionary lesson in the tension between competition among suppliers of rules and the ability of any one supplier to commit credibly to enforce its rules").

165 Amir N. Licht, *Bonding and Dominance in Securities Markets: Cross-Listing and Corporate Governance* 23 (unpublished working paper, Nov. 26, 2002), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=367501.

U.S. disclosure, accounting, and auditing standards.[166] This may or may not have been a good idea, but it certainly contradicted the theory that the NYSE would propose higher standards for foreign issuers so that those issuers could bond their quality to the market.

Pritchard essentially concedes that when profits are nakedly at stake, the exchanges will sacrifice investors, but hopes that in less conflicted settings the NYSE will show more backbone in standing up to fraud and other actions that threaten investor welfare.[167] But for the past seventy years the SEC has provided most of the rigidity in the NYSE's spine.[168] Therefore, there is no reason to believe that exchanges could ever serve as primary lawmakers for securities regulation or as viable sole regulators.[169]

3. *2000–Present*

Most pro-investor reforms that the NYSE has made over the years simply would not have occurred absent government pressure and a motive to buy off regulation.[170] Professor Thompson notes that "[t]he record of recent listing changes . . . suggests the NYSE responds more to a SEC push than to demand from investors."[171] Consider the recent scandals that made the names of securities analysts Henry Blodgett and Jack Grubman infamous. As Professors Fisch and Sale have pointed out:

> The NYSE and the NASD are run by, and primarily are accountable to, their members, the brokerage firms. Given the importance of investment

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[166] Richard C. Breeden, *Foreign Companies and U.S. Securities Markets in a Time of Economic Transformation*, 17 FORDHAM INT'L L.J. S77, S95 (1994).

[167] Pritchard, *Markets as Monitors*, *supra* note 139, at 1014.

[168] *See* Dombalagian, *supra* note 150, at 1082 (noting that throughout the 1970s and 1980s, the SEC pressured the NYSE and other exchanges to improve their listing standards); Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation*, 38 WAKE FOREST L. REV. 961, 977 (2003) (making a similar point).

[169] *See* DAVID P. MCCAFFREY & DAVID W. HART, WALL STREET POLICES ITSELF: HOW SECURITIES FIRMS MANAGE THE LEGAL HAZARDS OF COMPETITIVE PRESSURES 184 (1998) ("Blunt external regulation, private legal action, and political and economic pressures produce some unsuitable outcomes and waste, but self-regulation does not work effectively without them.").

[170] *See* Karmel, *Future*, *supra* note 159, at 327 ("Historically, listing standards were seen as a substitute for government regulation. The NYSE argued that if its listing standards for securities offered for sale adequately protected the investing public, then government regulation would be unnecessary.").

[171] Thompson, *supra* note 168, at 975.

> banking business for member firms, it is unrealistic to expect the SROs [(self-regulatory organizations)] actively to curtail a structure that promotes these operations .... [B]rokerage firms often benefit more directly from analysts' work through proprietary trading in covered securities. It is not surprising, then, that the scope of the regulatory response by the SROs has been limited and that the SROs have failed effectively to enforce even the monitoring functions that they self-prescribed. The SROs have little reason to disturb the status quo.[172]

Another recent example is the NYSE's failure to police widespread illegal trading by floor brokers.[173] Even disastrously pro-industry SEC head Harvey Pitt noted that exchanges such as the NYSE and NASDAQ were reluctant to be the first to raise listing standards, "for fear of giving the other a competitive advantage."[174] And when NASDAQ created the BBX with the notion of imposing corporate governance standards and enticing its premier Bulletin Board companies to list, few signed up. The BBX was scrapped and fraud continued to flourish on the OTC.[175]

The influx of competition by new electronic exchanges has placed even more downward pressure on the major exchanges.[176] Ultimately, "stock exchanges are mostly concerned with their own survival and prosperity,"[177] and when stringent listing requirements are inconsistent with those goals, they may be quickly jettisoned.

Although theoretically exchanges can signal their quality by denying listings to questionable companies, historically this has rarely occurred.[178]

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[172] Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1096 (2003).

[173] *See* Susanne Craig & Laurie P. Cohen, *SEC Takes Another Look at Grasso*, WALL ST. J., Nov. 3, 2003, at C11 (quoting SEC report noting that investors were shortchanged in trades involving two billion shares).

[174] Albert B. Crenshaw, *SEC to Toughen Rule on Option Plans*, WASH. POST, Dec. 20, 2001, at E1 (citing Pitt).

[175] Carrie Coolidge, *Under the Counter*, FORBES GLOBAL, Nov. 24, 2003, at 70 (noting that the filings with NASD "can very well be garbage").

[176] *See* Coffee, *Racing Towards the Top*, *supra* note 5, at 1818 ("ECNs erode the incentive for an exchange to invest in reputational capital or to maintain high listing standards if the exchange cannot fully capture the trading in that security.").

[177] Amir N. Licht, *David's Dilemma: A Case Study of Securities Regulation in a Small Open Market*, 2 THEORETICAL INQUIRIES LAW 673, 706 (2001) [hereinafter Licht, *David's Dilemma*].

[178] Karessa Cain, *New Efforts to Strengthen Corporate Governance: Why Use SRO Listing Standards?*, 2003 COLUM. BUS. L. REV. 619, 651 (noting how infrequently exchanges delist companies); CHARLES R. GEISST, DEALS OF THE CENTURY: WALL STREET, MERGERS, AND THE MAKING OF MODERN AMERICA 21 (2004) (same).

The General Motors episode illustrates why. While it has been argued that "market participants . . . have a strong market incentive to correct failures . . . [but] regulators ensconced with monopoly power lack any such incentive,"[179] over and over again it has been the SEC and Congress, not the market participants, that have cleaned up the market's messes.

The SEC has been criticized for tending to be reactive, creating new rules only when crises come to the fore. This is a plausible criticism,[180] but one may condemn the exchanges in much stronger terms. The NYSE and NASD tend to enact reforms only after (a) crises occur, (b) they learn of the crises, (c) outside entities learn of the crises and the exchanges' failure to do anything about them, and (d) outside entities threaten to impose state or federal regulation upon the exchanges unless they take action.[181]

Even if stock exchanges wished to enforce disclosure and antifraud rules vigorously, they would have difficulty doing so.[182] As Romano notes, government regulation (she prefers the state variety) "does . . . offer some decided benefits over stock exchange regulation: a more effective mechanism of private dispute resolution for securities suits against issuers, and a public enforcement system, should the deterrent effect of criminal prosecution for securities law violations be a necessary complement to civil liability."[183] Exchanges have a minimal arsenal of remedies and enforcement tools at their

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179 Stephen J. Choi, *A Framework for the Regulation of Securities Market Intermediaries*, 1 BERKELEY BUS. L.J. 1, 25 (2004).

180 The SEC is attempting to remedy its short-term focus. The SEC recently created a fifteen-person Office of Risk Assessment with the responsibility of looking ahead to attempt to spot problems before they become significant. *See* Adrian Michaels, *The Patience Behind the New-Look SEC*, FIN. TIMES, Feb. 17, 2004, at 33 (interviewing Peter Derby, head of the Office of Risk Assessment).

181 Although proponents of exchange-based regulation have no convincing response to the evidence that exchanges avoid enforcing their own rules because it might create bad publicity, they suggest that government regulators may also suppress evidence of fraud in order to portray the markets within their jurisdiction as uncorrupted. Adam C. Pritchard, *Self-Regulation and Securities Markets*, REGULATION, Spring 2003, at 32, 38 [hereinafter Pritchard, *Self-Regulation*]. But this response is not only inconsistent with most of the history of the SEC, it is also inconsistent with the argument that governmental agencies inevitably attempt to expand their own fiefdoms. *See* James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 NW. J. INT'L L. & BUS. 119, 205 (1996) (suggesting an SEC tendency to "safeguard its own importance").

182 *See* Dombalagian, *supra* note 150, at 1095 (noting how difficult it is for exchanges, even if properly motivated, to punish systemic fraud or prosecute wrongdoing that profits members); Gretchen Morgenson, *Big Board Is Far From Forefront When It Comes to Policing*, N.Y. TIMES, Sept. 22, 2003, at C1.

183 ROMANO, ADVANTAGE, *supra* note 35, at 145.

disposal even if they wanted to stop fraud by listing companies.[184] Exchange-based regulation would be greatly impeded because the exchanges' primary mechanism for resolving disputes, arbitration, cannot accommodate class actions.[185]

Beyond this, exchanges impose listing requirements that typically exclude large percentages of the very firms (a) that are most likely to commit fraud, and (b) whose owners might profit from mandatory disclosure.[186] Such firms would not even be within the realm of an exchange-enforced system.

Ultimately, the federal securities acts worked because "enforcement by the federal government was seen as more credible because it may have been seen as less subject to capture by insiders on exchanges."[187] In the pre-1933 era, the *threat* of state and particularly federal regulation forced the NYSE to impose moderate levels of regulation upon its listing companies. Since 1933, continuing SEC pressure has accounted for most of the pro-investor reforms that the NYSE and other exchanges have adopted.[188] Examples of reforms made by the exchanges that were functionally mandated by the SEC range

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[184] Edward Rock, *Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure*, 23 CARDOZO L. REV. 675, 697 (2002) (noting numerous limitations of the NYSE and other exchanges, especially an inability to impose criminal sentences).

[185] Romano, *Empowering Investors*, *supra* note 48, at 2400. *See also* Erik Berglof & Stijn Claessens, *Corporate Governance and Enforcement* 23 (World Bank Policy Research, Working Paper No. 3409, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=625286 (noting that exchanges and other SROs will need "some backing up from higher levels of government or from the judicial system" to begin to effectively regulate).

[186] Ferrell notes that "some exchanges require that a firm be profitable for a certain number of years before they are even eligible for listing, exactly those firms that are least likely to have internal sources of capital or well-established ties to financial institutions." Ferrell, *supra* note 146, at 27.

[187] *See* RAGHURAM G. RAJAN & LUIGI ZINGALES, SAVING CAPITALISM FROM THE CAPITALISTS 160 (2003). Certainly the SEC is also less likely to be captured than state regulators in a system of regulatory competition. *See* Bebchuk, *Desirable Limits*, *supra* note 11, at 1503 ("[T]here are some reasons to believe that the lobbying power of manager interest groups relative to that of public shareholder interest groups is stronger on the state level than on the federal level.").

[188] When exchange standards match or exceed SEC standards, it is only because the SEC has "encouraged" the exchanges. *See* Joseph A. Franco, *Why Antifraud Prohibitions Are Not Enough: The Significance of Opportunism, Candor and Signaling in the Economic Case for Mandatory Securities Disclosure*, 2002 COLUM. BUS. L. REV. 223, 322 n.202; Helen S. Scott, *The SEC, The Audit Committee Rules, and the Marketplaces: Corporate Governance and the Future*, 79 WASH. U. L.Q. 549, 566 (2001) (noting the SEC's prominent role in exchange-based corporate governance rules).

from the 1977 requirement that listed companies have an audit committee made up of independent members,[189] to the 1994 decision to reinstitute a form of one-share, one-vote,[190] to a wide variety of corporate governance reforms enacted in 2002.[191] Just as the federal government is the main countervailing power keeping Delaware from racing to the bottom in order to prevent corporations from fleeing the state, so is the SEC the primary force elevating the conduct of exchange-based regulation. If in either context federal pressure were removed, the results would be unfortunate.[192]

VI. INTERNATIONAL STOCK EXCHANGE COMPETITION

A. *Existence of Competition*

In the international and domestic spheres, stock exchanges seem to have more incentive to compete for listings than nations do to compete for incorporations or to provide securities regulation. However, when DaimlerChrysler AG listed on the New York Stock Exchange, the NYSE ended up with only five percent of the stock trading volume, which certainly minimized its incentive to attract European and other international issuers.[193] This is consistent with experience, for "it has traditionally been tough for new entrants to prise trading volume away from incumbents."[194]

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[189] In 1977, the NYSE adopted a rule requiring listed domestic companies to have an audit committee comprised solely of independent directors. "The voluntariness of the NYSE's adoption of this rule was debatable." Karmel, *Future*, *supra* note 159, at 340.

[190] *See* Richard A. Booth, *The Uncertain Case for Regulating Program Trading*, 1994 COLUM. BUS. L. REV. 1, 47 n.113 (1994) (noting the SEC's efforts); Rock, *supra* note 184, at 699 ("The one-share, one-vote controversy—whatever one thinks about the merits of the rule—provides a cautionary lesson in the tension between competition among suppliers of rules and the ability of any one supplier to commit credibly to enforce its rules.").

[191] *See* LOWENSTEIN, *supra* note 86, at 89 (noting that the SEC is the primary mover behind these listing changes); Thompson, *supra* note 168, at 977–81 (same).

[192] *See* Franco, *supra* note 188, at 329 ("As disclosure regimes proliferate, all issuers may in some sense be worse off because it will be more difficult to gauge the risk of disclosure opportunism.").

[193] *See* Andrew Karolyi, *DaimlerChrysler AG, The First Truly Global Share* 15 (Ohio State Univ. Dice Ctr., Working Paper No. 99–13, 2001), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract id= 185133.

[194] Jeremy Grant, *Eurex Prepares Launch of New US Exchange*, FIN. TIMES, Feb. 9, 2004, at 22 (describing low expectations for Eurex, the European derivatives exchange, in its attempt to take on the Chicago Board of Trade).

Not surprisingly, then, Professor Coffee recently noted that "[t]he history of head-to-head inter-market competition among stock exchanges is conspicuous by its absence."[195] Furthermore, as the global securities market becomes more technologically sophisticated, it is possible that fragmentation will create a situation in which "no trading site will have enough incentive to invest heavily in monitoring or enforcement, and the concept of listing as a bonding device will begin to disappear."[196]

As with the case for state regulatory competition in corporate codes and securities law regulation, the relative absence of stiff competition among international bourses does not bode well for proposed regulatory competition regimes. However, recently there has been at least modest competition among bourses in Frankfort, Paris, Scandanavia, London, and elsewhere with those in America. If such competition were to grow in the future, in what direction might it flow?

B. *Race to the Bottom*

European corporations often choose to list in New York (and in London), even though they will have to disclose more information on those exchanges than if they listed their shares elsewhere. One theory is that they are "bonding" themselves to investors, signaling their strength and good intentions. Although this is no doubt true for some issuers, generally foreign companies do not go to the NYSE primarily because their managers desire to disclose information, subject themselves to antifraud liability, and "bond" themselves to investors. Rather, they go there for the same reason that Willie Sutton used to go to banks—that's where the money is.[197] And that's where the visibility is.

The bonding theory also minimizes the special concessions that the exchanges[198] and the SEC have given to foreign listing companies.[199] If

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[195] Coffee, *Racing Towards the Top*, *supra* note 5, at 1769.

[196] Donald C. Langevoort, *Structuring Securities Regulation in the European Union: Lessons from the U.S. Experience* 19 (Georgetown Univ. Law Ctr., Georgetown Pub. Law Research, Working Paper No. 624582, 2004), *available at* http://ssrn.com/abstract=624582.

[197] *See* Breeden, *supra* note 166, at S81 (noting that the reason more companies do primary offerings in the U.S. than anywhere else is "the ready availability of capital"); Tung, *Monopolists*, *supra* note 5, at 1397 (noting that the U.S. offers "the largest, deepest, and most liquid market in the world . . . [with the] largest national pool of investors").

[198] Amir N. Licht, *Cross-Listing and Corporate Governance: Bonding or Avoiding?*, 4 CHI. J. INT'L L. 141, 151 (2003) [hereinafter Licht, *Cross-Listing*]. The SEC has approved these exemptions. *Id.*

firms must disclose as a precondition to accessing capital in New York or London, they often will. But the disclosure and corporate governance requirements are an impediment, not an attraction, at least for the managers who make the decisions.[200] Indeed, they are the most important deterrent to cross-border listings.[201] That accounts for the general trend, which is for cross-listed companies to choose destination nations with *lower*, not higher, accounting standards than those of their origin countries.[202] Many more foreign companies would list in London or New York if they did not have to disclose as much information about themselves or expose their managers to

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[199] *Id.* Also, the SEC has not been as active as it might have been in enforcing rules against foreign issuers, so the bond is not as tight as it should be. *See* Jordan I. Siegel, *Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Laws?*, 75 J. FIN. ECON. 319, 346–47 (2005) [hereinafter Siegel, *Foreign Firms*] (noting that procedural obstacles also make private enforcement of U.S. securities laws by foreign investors problematic); *see also* Jordan I. Siegel, Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Laws? (Feb. 4, 2004) (draft of working paper), *available at* http://www.people.hbs.edu/jsiegel/jsiegel_bonding_paper_100804.pdf [hereinafter Siegel, 2004 Draft] (draft of article including text and tables). Siegel believes that firms may cross-list voluntarily in the U.S. to gain reputational capital by disclosing more than they are required to in their home country, *id.* at 33–39, but that the reputational bond is not supplemented by any meaningful legal bond. Companies that cross-list and do not steal from shareholders do well. Those that cross-list and do steal from shareholders suffer reputational harm, as well they should. *Id.* at 38–39.

Coffee counters this study with the argument that even if the SEC does not file many actions, the threat still may carry deterrence and the actions it does bring are sometimes high profile and therefore may create the impression in foreign managers' and investors' minds that this is a significant threat. Coffee, *Racing Towards the Top*, *supra* note 5, at 1794–96. There is something to this argument, but foreign fraud is difficult for the SEC to detect and necessarily a low priority. Ferrell, *supra* note 146, at 38.

The SEC should be faulted for allowing these exclusions, because investors in other nations count to some extent upon SEC supervision of their companies. *See* John Authers & Sara Silver, *It's Absurd for the SEC to Use a Mexican Company and Mexican Citizens to Try to Impose US Regulations . . .*, FIN. TIMES, Jan. 20, 2005, at 17 ("[In Mexico] there is an implicit decision that the more foreign financial actors supervise Mexican entities the more secure the Mexican financial system will be."); *see also* Siegel, *Foreign Firms*, *supra*, at 322 (finding that the SEC and minority shareholders have not effectively enforced U.S. law against cross listed firms).

[200] James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 STAN. J.L. BUS. & FIN. 51, 72 (1997) ("[SEC] disclosure requirements impose significant costs upon a foreign company listing its securities in the U.S., and these costs affect a company's listing decision.").

[201] G. Andrew Karolyi, *Why Do Companies List Shares Abroad? A Survey of the Evidence and Its Managerial Implications*, 7 FIN. MKTS., INST. & INSTRUMENTS 1 (1998) [hereinafter Karolyi, *Why List*].

[202] Licht, *Cross-Listing*, *supra* note 198, at 158.

higher accountability and liability.[203] Amir Licht surveyed several empirical studies and concluded:

> To the extent the corporate governance issues play a role in the cross-listing decision, it is a negative role. The dominant factors in the choice of cross-listing destination markets are access to cheaper finance and enhancing the issuer's visibility. Corporation governance is a second-order consideration whose effect is either to *deter* issuers from accessing better-regulated markets or to induce securities regulators to allow foreign issuers to avoid some of the more exacting domestic regulations.[204]

When foreign issuers explain why they list on U.S. exchanges, their answers have little or nothing to do with bonding their reputation to investors by disclosing more information.[205] When they explain the disadvantages or obstacles to listing on U.S. exchanges, they consistently mention increased disclosure, even though, as noted above, they are exempted from many of the U.S. requirements for domestic firms.[206]

Corporate managers typically drive the decisions whether to cross-list securities, and their personal interests are often at cross-purposes with the interests of companies' owners.[207] They are interested in less disclosure of transactions that profit them personally and with less supervision, accountability, and transparency.[208] They prefer the higher level of control

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[203] *See* Karolyi, *Why List*, *supra* note 201, at 35 (finding that "stringent disclosure requirements are the greatest impediment to cross-border listings").

[204] Licht, *Cross-Listing*, *supra* note 198, at 142 (emphasis added).

[205] The reasons they give include (a) business reasons such as increased visibility or facilitating a U.S. acquisition, (b) financial reasons, such as better price and liquidity, (c) industry specific reasons such as the fact that competitors have also listed, and (d) expansion of U.S. shareholder base because that is where the money is. Fanto & Karmel, *supra* note 200, at 66–70.

[206] Licht, *Cross-Listing*, *supra* note 198, at 156–57 ("[T]he surveys consistently indicate that if increased disclosure levels under U.S. regulations play any role, then this role is definitely a negative one.").

[207] Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195, 204 (2004) (also see sources cited therein) [hereinafter Licht, *Plug-Ins*].

[208] Licht, *David's Dilemma*, *supra* note 177, at 682. Licht notes:

> [M]anagers would prefer to list on a market without a duty to disclose executive compensation with a personal breakdown; controlling shareholders would prefer to list on a market with lax disclosure and approval requirements regarding interested party transactions; and insiders in general might prefer to list on a market with a lenient anti-insider trading regime or weak enforcement.

and ability to avoid accountability and liability for self-dealing that comes with avoiding higher levels of disclosure.[209] Indeed, several empirical studies support the conclusion that "insiders may take advantage of cross-listings to derive private benefits."[210] The bottom line is that most cross-listing companies do so in spite of those standards rather than because of them.[211]

Exchanges are aware of these motivations and cater to them. Just as the New York Stock Exchange in the early 1990s weakened its listing standards rather than delisting a prominent company like General Motors, exchanges across the world often choose to bend rather than enforce the rules. For example, the Deutsch Bourse failed to delist Porsche AG, even though Porsche refused to comply with the exchange's disclosure requirements.[212]

Not surprisingly, then, international exchange competition tends to trend downward:

- The London Stock Exchange (LSE) gained substantial ground on the NYSE in the 1990s, in part because it had less rigorous listing requirements.[213]

- The LSE outcompeted the Paris Bourse head-to-head by allowing dealers to delay the reporting of block trades for several days. Although this damaged transparency and therefore hurt investors, it was so popular with the dealers that the Paris exchange was forced to change its rules to allow this tactic as well.[214]

Id.

209 Ferrell, *supra* note 146, at 16.

210 Licht, *Plug-Ins*, *supra* note 207, at 206 (citing several studies). This should not be surprising given evidence that when managers of American companies decide to list their companies' shares on exchanges, they manage to act on private information before exchange listings and delistings. *See* Gwendolyn P. Webb, *Evidence of Managerial Timing: The Case of Exchange Listings*, 22 J. FIN. RES. 247 (1999).

211 This is not to say that all issuers in all circumstances seek to provide only the lowest possible levels of disclosure. That would overstate the case substantially. Eric J. Pan, *Harmonization of U.S.-EU Securities Regulation: The Case for a Single European Securities Regulator*, 34 L. & POL'Y INT'L BUS. 499, 531 (2003).

212 *See* Scott Miller, *For Porsche Investors, Disclosure Matters Less than Rocking Results*, WALL ST. J., Aug. 13, 2001, at C14 (noting that investors did not seem to mind limited disclosure so long as the company appeared to be making lots of money).

213 *See* Jay D. Hansen, Note, *London Calling?: A Comparison of London and U.S. Stock Exchange Listing Requirements for Foreign Equity Securities*, 6 DUKE J. COMP. & INT'L L. 197, 221 (1995) ("[C]ompanies may meet [LSE] listing requirements without compiling and disclosing as much information as is required for a U.S. listing.").

214 Robert Bloomfield & Maureen O'Hara, *Can Transparent Markets Survive?*, 55 J. FIN. ECON. 425, 426 (2000).

- When Israel's stock exchange attempted to lure Israeli companies listed only on U.S. stock markets by raising its listing standards, it learned that many issuers had gone to the U.S. to avoid the more stringent Israeli disclosure requirements and had no interest in returning.[215] The American standards functionally "became the ceiling, [not the floor,] for any future [Israeli] regulatory reform."[216]

- Brazil's Novo Mercado set very high standards in order to attract companies who would "bond" their reputation by complying. It was a great idea theoretically, but few companies were interested in so bonding.[217]

- Germany's Neuer Markt has been touted as illustrating the success of voluntary private contracts for investor protection rather than legal regulation.[218] Unfortunately, the Neuer Markt, with its advertised high standards for listing companies, totally collapsed when a wave of accounting scandals, sham stocks, and insider trading frauds came to light.[219]

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[215] Licht, *David's Dilemma*, *supra* note 177, at 703 ("For such issuers, piggybacking on the U.S. market was a ride to the bottom.").

[216] *Id.* at 702. *See also* Amir N. Licht, *Managerial Opportunism and Foreign Listing: Some Direct Evidence*, 22 U. PA. J. INT'L ECON. L. 325, 347 (2001) (noting that "managerial opportunism is a significant factor in decision-making processes in public corporations" and arguing that the fact that Israeli companies listed in the U.S., which allowed relaxed disclosure for foreign firms, was a case of racing to the bottom); Tung, *Monopolists*, *supra* note 5, at 1406 (also noting this race-to-the-bottom effect regarding the listing of Israeli companies).

[217] *See* Felix Salmon, *Beware of the Bull*, LATINFINANCE, Dec. 2004, at 26 ("[The Novo Mercado] has attracted just five companies with an aggregate market capitalization of $8.52 billion in November—less than 4% of the value of all Brazilian stocks."). As this Article was being edited, more encouraging information came out of Brazil, which instigated new reforms after the initial reforms failed. *See* Antonio Gledson de Carvalho & George G. Pennacchi, *Can Voluntary Market Reforms Promote Efficient Corporate Governance? Evidence from Firms' Migration to Premium Markets in Brazil* 18 (January 25, 2005) (unpublished working paper), *available at* http://ssrn.com/abstract=678282 (finding that a new market, Bovespa, began innovations that give "credence to the view that competition among the world's stock exchanges can lead to higher overall standards for corporate governance and disclosure").

[218] Choi, *Issuer Choice*, *supra* note 118, at 821.

[219] *See* Michael Forman, *Scandal, Not Scant Volume, Dooms Neuer Markt*, SECURITIES INDUS. NEWS, Oct. 7, 2002 (noting that "it was a parade of scandals—from fraud, bankruptcies and illegal insider trading—that truly doomed" the Neuer Markt); *Current Economic Conditions*, CANADIAN ECON. OBSERVER, Oct. 2002, at 1.7 (noting that the Neuer Markt was soon to close "after the dot-com crash and mounting reports of

- Today, the NYSE is not competing with the LSE by touting its bonding opportunities under Sarbanes-Oxley's Section 404; rather, the LSE is urging companies to list with it to avoid the burdens of developing reliable financial controls.[220]

There are many good reasons to list on exchanges with relatively higher listing standards. Companies get increased securities analyst coverage which, in turn, increases firm value.[221] Stock price performance may improve.[222] Companies from civil law nations can profit by signaling to shareholders that they intend to provide more protections to shareholders.[223] But less than ten percent of companies eligible to cross-list do so, [224] and those that cross-list tend to do so for less admirable reasons. In large part because corporate insiders pursue their own interests at the expense of outsiders,[225] "the impact of financial globalization has been remarkably limited."[226] Cross-listing will continue to increase, of course, as international trends in securities markets accelerate. But this most likely will continue to occur in spite of, rather than because of, higher listing standards. Therefore, the focus for improving the

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accounting fraud"); Rachel Stevenson, *Scandals and Bankruptcies Destroy Germany's Neuer Markt*, THE INDEP. (LONDON), Sept. 27, 2002, at 23 ("A number of companies listed on the [Neuer Markt] have gone bankrupt, directors have been charged with insider dealing and fraud, and accounts have been questioned.").

[220] *See* Andrei Postelnicu, *NYSE Considers Earlier Start to Challenge Europe*, FIN. TIMES, Jan. 15–16, 2005, at 31. The head of the NYSE responded by pointing out that pressure stemming from Enron and Parmalat would cause European regulators to emulate U.S. regulation and would therefore soon improve NYSE's relative position regarding listings. *See* John Gapper, *NYSE Chief Expects Europe to Move Closer*, FIN. TIMES, Jan. 28, 2005, at 31.

[221] Mark H. Lang et al., *ADRs, Analysts, and Accuracy: Does Cross Listing in the U.S. Improve a Firm's Information Environment and Increase Market Value?* 20 (NYSE, Working Paper No. 2002–06, 2002), *available at* http://www.nyse.com/pdfs/2002-06.pdf.

[222] *See* Stephen R. Foerster & G. Andrew Karolyi, *The Effects of Market Segmentation and Investor Recognition on Asset Prices: Evidence from Foreign Stocks Listing in the United States*, 54 J. FIN. 981, 1008 (1999) (finding positive, permanent market reactions for Asian firms that list the shares in the U.S.).

[223] *See* William A. Reese, Jr. & Michael S. Weisbach, *Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings*, 66 J. FIN. ECON. 65, 66–67 (2002).

[224] *See* Craig Doidge et al., *Why Are Foreign Firms Listed in the U.S. Worth More?* (Ohio State Univ. Dice Ctr., Working Paper No. 2001–16, 2001) *available at* http://ssrn.com/abstract=285337.

[225] *See* Licht, *Plug-Ins*, *supra* note 207, at 205 ("A sober analysis, especially of recent unpublished studies, indicates that the bonding hypothesis does not receive support from the extant empirical evidence while the avoiding hypothesis does.").

[226] Rene M. Stulz, *The Limits of Financial Globalization* (NBER, Working Paper No. W11070, 2005), *available at* http://www.nber.org/papers/W11070.

fullness and accuracy of disclosure should be upon "sustained efforts by law makers and regulators in firms' home countries,"[227] rather than through exchange-based competition.

VII. AN EXPLANATION

In this examination of various forms of regulatory competition to provide securities law, two questions arose repeatedly. First, why is there so little competition? Other authors have stressed that the incentives are simply not there for legislators to toil away to produce the most efficient corporate or securities laws in order to attract incorporations and firms wishing to be governed by their securities laws.

This Article focuses on the second question: why is the competition that does exist usually ambling toward the bottom rather than racing to the top? Why does the "bonding" theory seem not to be realized in practice? The key reason is that to the extent that states or nations or exchanges do wish to compete for incorporations or listings, they know that managers make the decisions and, unfortunately, managers' interests and shareholders' interests are too often ill-aligned.

A. *Managers Make Self-Serving Decisions*

Regulatory competition's key premise is that "no government entity can know better than market participants what regulations are in their interest, particularly as firms' requirements are continually changing with shifting financial market conditions."[228] Proponents of regulatory competition minimize the fact that insofar as corporations are concerned, the "market participants" who will be making these decisions are corporate managers. These proponents assume that with this superior knowledge, if, all things being equal, it is best for shareholders to impose high levels of mandatory disclosure, officers and directors will choose it. If, all things being equal, it is best for shareholders to choose a regime with stringent insider trading controls, officers and directors will choose it. If, all things being equal, it is best for shareholders to have stringent limitations upon and full disclosure of executive and director compensation, officers and directors will choose it. If, all things being equal, shareholders are best served by strong civil and criminal liability for misfeasance and malfeasance by managers, those managers will choose it. These assumptions are facially implausible. Admati and Pfleiderer have noted that "[f]ull voluntary disclosure . . . rarely seems to

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227 Licht, *Cross-Listing*, *supra* note 198, at 163.

228 Romano, *Empowering Investors*, *supra* note 48, at 2365.

occur in reality, and firms typically do not disclose more than regulation requires."[229] In a post-Enron world, blind faith in manager good faith seems positively quaint.[230]

1. *Conscious Self-Interest*

Both managers' conscious desire to advance their personal interests and the self-serving bias that causes them to unconsciously advance their own agendas at the expense of their shareholder-principals make it unlikely that managers will be able to make the incorporation, choice-of-regime, or listing decisions objectively in the best interests of the firm.[231]

To begin with conscious self-interest, a quick reading of Bebchuk and Fried's recent book on executive compensation[232] or any of the Enron exposés[233] will quickly disabuse anyone of the notion that one may safely assume that managers choose incorporation sites (or make any other decision regarding the firm) without making their own best interests a primary consideration. Top executives take care of themselves and they take care of each other when they serve on one another's boards.

Too often managers will act to protect their perquisites, even at the expense of their shareholders.[234] Academic studies demonstrate:

- In public corporations, managers push for staggered boards, limits to shareholder bylaw amendments, supermajority requirements for

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[229] *See* Anat R. Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 REV. FIN. STUD. 479, 480 (2000).

[230] Greenwood notes that "regardless of where it is made, state corporate law either is directed to the perceived needs of corporate management or it is empty, 'rusted girders, internally welded together and containing nothing but wind,' because all management need do to avoid unwanted regulation is to reincorporate in Delaware." Greenwood, *supra* note 88, at 388.

[231] *See* Prentice, *Strong SEC*, *supra* note 3, at 32–37.

[232] LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION (2004) (painting an ugly picture of managers pervasively subordinating shareholder interests in order to maximize their own compensation).

[233] *See, e.g.*, KURT EICHENWALD, CONSPIRACY OF FOOLS (2005) (painting a vivid picture of managers consciously and subconsciously sacrificing shareholder welfare for personal advancement); BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON (2003) (same).

[234] *See* Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 640 (1989) ("Evidence concerning targets also suggests that many managers pursue their own objectives even if shareholders lose."). Black also notes that acquirers' managers often act contrary to their shareholders' interests as well. *Id.*

mergers and charter amendments, poison pills, and golden parachutes, even though all of these limit shareholder control and reduce shareholder value.[235]

- In IPOs, managers install antitakeover provisions, though these also undermine shareholder value.[236]
- Just before IPOs, managers are more likely to manipulate discretionary accruals to beautify the financial statements if they intend to sell their own shares in an "attempt to maximize their personal wealth at the expense of other investors."[237]
- Managers engage in self-enriching related-party transactions, even though such transactions are negatively associated with their firms' stock market returns.[238]
- Managers often report illusory earnings needed to earn short-term bonuses,[239] even though their companies will have to pay taxes on those fake earnings.[240]

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[235] *See* Lucian Bebchuk et al., *What Matters in Corporate Governance?* (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 491, 2004), *available at* http://papers.ssrn.com/abstract_id=593423 (producing empirical results indicating that these six factors adversely affect shareholder value).

[236] Daines & Klausner, *supra* note 54 (finding that anti-takeover provisions are common in IPOs and that they are explained by management entrenchment).

[237] *See* Masako Darrough & Srinivasan Rangan, *Do Insiders Manipulate Earnings When They Sell Their Shares in an Initial Public Offering?*, 43 J. ACCT. RES. 1, 31 (2005).

[238] Some economists have argued that companies benefit from related-party transactions, but this turns out not to be the case. *See* Elizabeth Gordon et al., *Related Party Transactions: Associations with Corporate Governance and Firm Value* (European Fin. Assoc. 2004 Maastricht Meetings, Paper No. 4377, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=558983.

[239] *See* Flora Guidry et al., *Earnings-Based Bonus Plans and Earnings Management by Business-Unit Managers*, 26 J. ACCT. & ECON., 113, 140 (1999) (reporting an empirical study finding "evidence . . . consistent with business-unit managers manipulating earnings to maximize their short-term bonus plans").

[240] Targets of SEC allegations of accounting fraud from 1996–2002, "[i]n aggregate, . . . paid $320 million to the taxing authorities as a result of overstating earnings by approximately $3.6 billion." *See* Merle Erickson, Michelle Hanlon, & Edward L. Maydew, *How Much Will Firms Pay for Earnings That Do Not Exist? Evidence of Taxes Paid on Allegedly Fraudulent Earnings* 5 (unpublished working paper, Nov. 1, 2002), *available at* http://ssrn.com/abstract=347420.

- Managers also "are more likely to fund intermediaries [such as auditors] that favor managers than those that effectively curb management opportunism."[241]
- Managers typically select accounting procedures that are most favorable to themselves even if they are not the most favorable procedures for their firm.[242]

In light of this evidence, it seems foolhardy to assume, as regulatory competition does, that managers will select the legal regime that best advances shareholder interests.

2. *Unconscious Bias*

Even managers who are consciously trying to serve their principals' best interests will be affected by the self-serving bias. This will tend to affect their gathering, processing, analyzing, and remembering of information, leading them to reach conclusions, unjustified by objective reality, about the firms' prospects and their responsibility for them.[243] They will tend to believe that the firms' best interests are served by maximizing manager discretion, compensation, and protection from liability. Put it all together, and some have concluded that conscious self-interest and unconscious bias are the reasons that "empire-building and excessive self-confidence are likely to be the main sources of corporate governance failures in developed market economies."[244]

B. *Restraints Do Not Work*

Theoretically, a number of nongovernmental restraints work to prevent manager self-interest from sacrificing investor interests. In reality, these restraints fail too often.

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241 *See* Choi & Fisch, *supra* note 141, at 275.

242 Dan S. Dhaliwal et al., *The Effect of Owner Versus Management Control on the Choice of Accounting Methods*, 4 J. ACCT. & ECON. 41, 52 (1982) (finding that managers pick the accounting method that is most favorable to them individually even if it is not most favorable to their firm).

243 *See* MAX H. BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 141–42 (5th ed. 2002) (describing this bias generally).

244 Berglof & Claessens, *supra* note 185, at 13 n.4.

1. *Market Restraints Fail*

The regulatory competition line of argument provides that the markets will discipline managers, forcing them to act in the best interests of shareholders or lose their positions. For a number of reasons, this is unduly optimistic, as experience in the Enron era resplendently illustrates.

a. *Issuers Access the Markets Infrequently*

Reputational constraints work best on companies that must access the capital markets.[245] Unfortunately, most public companies access the equity markets only infrequently,[246] so the market's opportunity to discipline the managers of those companies by punishing their firms in the marketplace when they try to access capital is spotty at best.

b. *Managers Are Willing to Leave Money on the Table*

Regulatory competition proponents further assume that managers will not choose regimes that exculpate them from fraud liability, for example, because if they do "investors will either not invest in the firm at all or will require a higher return on the investment."[247] They ignore the unhappy fact that crooks will gladly leave some money on the table that would have gone into corporate coffers had they not exempted themselves from fraud liability given that what money does come in can be appropriated with near

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[245] *Id.* at 17 ("The obvious problem with self-enforcement through reputation is that it relies on future interactions, e.g., that [firms] will have to come back to the stock market for more funding."). The authors go on to note:

> Moreover, since the costs of building reputation are sunk, they may not deter future violations if the gains are sufficiently large. An additional problem of the reputation mechanism is that memory, particularly in stock markets, may be short. With losses to investors from previous violations already incurred and new investors coming into the market, considerations of new investments may not be affected by previous actions, thus weakening the commitment power of reputation in financial markets.

Id.

[246] *See* Troy A. Paredes, *Too Much Pay, Too Much Deference: Is CEO Overconfidence the Product of Corporate Governance?* 23 (Washington Univ. Sch. of Law Faculty Series, Working Paper No. 04–08–02, 2004), *available at* http://ssrn.com/abstract=587162 (noting that "many companies need to raise capital relatively infrequently" and that even poorly performing companies can "almost always" raise funds).

[247] Romano, *Empowering Investors*, *supra* note 48, at 2366.

impunity.[248] Many managers will gladly forfeit funds that might be helpful to the firm in the future in exchange for personal liability protection now.

Some regulatory competition advocates concede that for companies that do not need to access the market for capital, reputation exerts no strong pressure. However, in the IPO setting, they claim that firms will have every incentive to cater to shareholder interests. For example, Choi and Pritchard have argued that IPO

> firms will have strong incentives to select regimes that maximize the total value of the company. At the time of the initial incorporation, these firms will select the takeover regime that maximizes value. . . . If such a rule is value maximizing, it will be adopted by the firm at the time of the initial public offering.[249]

Yet again, however, theory does not jibe with empirical evidence. At IPOs, officers often leave 15%, 20%, even 40% of the money they could raise for the company on the table through underpricing.[250] They do this particularly in cases in which their share of the overall take is relatively small and when their families and friends are part of "directed share programs" and thereby are enabled to buy shares at the low IPO price.[251]

And, contrary to regulatory competition theory, they adopt anti-takeover devices that harm shareholders too, as Choi and Pritchard admit,[252]

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[248] *See* Prentice, *Whither Securities Regulation?*, *supra* note 2, at 1446–47 (making this argument).

[249] Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 982–83 (2001) [hereinafter Choi & Guzman, *Choice*].

[250] Alexander Ljungqvist, *IPO Underpricing*, *in* HANDBOOK IN CORPORATE FINANCE: EMPIRICAL CORPORATE FINANCE 1 (B. Espen Eckbo ed., forthcoming 2005) (noting that IPO underpricing averaged "21% in the 1960s, 12% in the 1970s, 16% in the 1980s, 21% in the 1990s, and 40% in the four years since 2000"). Part of officers' motivation for leaving millions on the table in the recent dot-com boom may have been the payoffs they received in the form of opportunities for personal allocations of other hot IPO shares offered by the underwriters they chose to take their firms public. *See Google's IPO: A Cartel-Buster*, ECONOMIST, May 8, 2004, at 14 (noting that "[i]nstitutional shareholders and corporate bosses were plied with IPO allocations in return for inflated commissions and future favours").

[251] *See* Alexander Ljungqvist & William J. Wilhelm, Jr., *IPO Pricing in the Dot-Com Bubble*, 58 J. FIN. 723, 750–51 (2003).

[252] Robert Daines & Michael D. Klausner, *Agents Protecting Agents: An Empirical Study of Takeover Defenses in Spinoffs* (Stanford Law Sch. John M. Olin Prog. in Law & Econ., Working Paper No. 299, 2004), *available at*

conceding that "such evidence may point out that firms even at the time of the initial public offering do not maximize firm value."[253] Furthermore, Daines and Klausner have found that when parent managers would personally benefit by entrenching the managers of companies that they spin off, they are much more likely to include takeover defenses in the spinoff's management structure.[254] These defenses will likely reduce the amount of money the firm can raise through the spin off, but managers apparently conclude that the personal benefit to them makes it worthwhile. Similarly, studies show that IPO firms commonly leave money on the table by adopting corporate governance schemes that do not maximize shareholder protection.[255]

c. *Managers Can Manipulate Numbers to Meet Bonus Targets*

One might argue that managers' interests can be aligned with those of shareholders by using incentive plans that tie managerial compensation to performance. Firms have been trying to do this for a decade and what we have ended up with is CEO compensation that has risen like a rocket, largely de-coupled from any performance criteria.[256] Attempts to re-couple compensation to performance face difficult hurdles, given managers' ability to manipulate earnings to favor short-term performance.[257] Even the

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http://papers.ssrn.com/paper.taf?abstract_id=637001 (finding that antitakeover provisions are common in IPOs and that they are explained by management entrenchment).

[253] Choi & Guzman, *Choice*, *supra* note 249, at 985.

[254] Daines & Klausner, *supra* note 252, at 25 (finding also that this entrenchment reduces share value in the parent).

[255] *See* Gretchen Morgenson, *New Stocks, Same Old Problems*, N.Y. TIMES, Jan. 23, 2005, at BU1 (citing study by Linda R. Killian).

[256] *See generally* BEBCHUK & FRIED, *supra* note 232.

[257] *See* Stephen J. Choi & Jill E. Fisch, *How to Fix Wall Street: A Voucher Financing Proposal for Securities Intermediaries* 40 (Law & Econ. Workshop, UC-Berkeley, Paper No. 11, 2002), *available at* http://repositories.cdlib.org/cgi/viewcontent.cgi?article=1047&context=berkeley_law_econ. The authors note:

> [M]anagement can exercise its control over the quality of the information in order to reduce the market's capacity for oversight. Earnings manipulation provides the classic example of this type of abuse. Management may be particularly prone to present an inflated picture of the firm's financial health in order to maintain their positions, to obtain performance-based bonuses or to increase the value of their stock or stock options. This may even lead managers to adjust the firm's operations to favor short term performance at the cost of the firm's long-run financial health.

Id.

instigators of the stock option craze, Kevin Murphy and Michael Jensen, now realize that managers can easily manipulate share prices in the short-term.[258]

As practiced, equity-based compensation facilitates rather than limits managerial opportunism.[259] Much empirical work supports this conclusion. For example, academic studies indicate that the more sensitive a CEO's option portfolio is to stock price, the more likely is the CEO's firm to manage earnings,[260] misreport its financial condition,[261] or commit accounting fraud.[262]

d. *Hostile Takeovers Are Not a Viable Restraint*

Some claim that the market for corporate control can constrain managers from making reincorporation or other decisions that hurt shareholders.[263] However, because tender offers are extremely costly,[264] they remain

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[258] Margaret M. Blair, *Directors' Duties in a Post-Enron World: Why Language Matters*, 38 WAKE FOREST L. REV. 885, 894 (2003).

[259] *See* McDonnell, *Stuck*, *supra* note 68, at 694.

[260] *See* Sarah McVay et al., *Trading Incentives to Meet Earnings Thresholds* (unpublished working paper, on file with the Univ. of Mich. Bus. Sch., July 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=555202 (finding common indicators of earnings management when managers sell more shares).

[261] *See* Natasha Burns & Simi Kedia, *The Impact of Performance-Based Compensation on Misreporting* (unpublished working paper, June 2004), *available at* http://ssrn.com/abstract=555903; Jap Efendi et al., *Why Do Corporate Managers Misstate Financial Statements? The Role of In-The-Money Options and Other Incentives* (unpublished working paper, Oct. 27, 2005), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=547922 (finding a strong link between the likelihood of an accounting restatement and the CEO's holding of in-the-money options).

[262] *See* Merle Erickson, Michelle Hanlon, & Edward L. Maydew, *Is There a Link Between Executive Compensation and Accounting Fraud?* 1 (unpublished working paper, Feb. 24, 2004), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=509505 (reporting empirical findings that "a one standard deviation increase in the proportion of compensation that is stock-based increases the probability of an accounting fraud by approximately 68%"). *See also* Bin Ke, *Do Equity-Based Incentives Induce CEOs to Manage Earnings to Report Strings of Consecutive Earnings Increases?* (unpublished working paper, Feb. 22, 2004), *available at* http://www.personal.psu.edu/faculty/b/x/bxk127/research/papers/earningduration.pdf (finding that firms with CEOs who have high amounts of equity incentives related to unrestricted stock or options immediately exercisable tend to exhibit more activities consistent with earnings management).

[263] *See* EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, *supra* note 38, at 213–15.

[264] *See* K. A. D. Camara, *Shareholder Voting and the Bundling Problem in Corporate Law*, 2004 WIS. L. REV. 1426, 1442 ("[A] significant takeover spread, well

relatively rare, and only a tiny fraction of American public companies ever face a hostile takeover bid.[265] Furthermore, most bids fail.[266] Many companies have staggered boards and poison pills and these tend to minimize the number of bids, reduce dramatically the number of successful bids, and overall reduce shareholder return.[267] The very fact that jurisdictions seem to cater to corporate managers by enacting takeover laws that allow poison pills and other defenses not only shows that takeovers are not a viable restraint, but undermines the entire race-to-the-top thesis.[268]

Furthermore, there is much evidence that the theoretical picture of efficient sharks searching for and finding underperforming companies with incompetent officers and then taking them over and replacing them with more competent managers[269] is only occasionally true.[270] Substantial evidence indicates that behavioral factors such as overconfidence by the managers of offerors may have more to do with why takeovers occur than any underperformance by target management.[271] The facts that (a) share

over twenty percent, must exist before a takeover artist will find painting worthwhile."); Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124, 125 (1994) (noting several reasons why hostile takeovers are an imperfect monitoring device).

265 Ninety-eight percent of mergers and acquisitions in the U.S. are friendly. *See* John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 TEX. L. REV. 271, 274 (2000).

266 *See* Gregor Andrade, Mark L. Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers* (Harvard Bus. Sch., Working Paper No. 01–070, 2001), *available at* http://ssrn.com/abstract=269313 (finding that hostile tender offers virtually disappeared in the 1990s); Lucian Arye Bebchuk et al., *The Powerful Anti-takeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) [hereinafter Bebchuk et al., *Staggered Boards*].

267 *See* Bebchuk et al., *Staggered Boards*, *supra* note 266, at 931.

268 *See* McDonnell, *Stuck*, *supra* note 68, at 696–97 (noting that if incumbent managers can protect their positions by incorporating in states with protective laws, they likely will be willing to suffer any pain caused by concomitant reduced stock prices).

269 *See* Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981) (theorizing without evidence that "the most probable explanation for unfriendly takeovers emphasizes their role in monitoring the performance of corporate managers").

270 *See generally* Robert A. Prentice & John A. Langmore, *Hostile Tender Offers and the "Nancy Reagan Defense": May Target Boards "Just Say No"? Should They be Allowed To?*, 15 DEL. J. CORP. L. 377, 420–25 (1990) (citing evidence inconsistent with this "pruning deadwood" thesis).

271 *See, e.g.*, Pamela R. Haunschild et al., *Managerial Overcommitment in Corporate Acquisition Processes*, 5 ORG. SCI. 528 (1994); Pekka Hietala et al., *What Is the Price of Hubris? Using Takeover Battles to Infer Overpayments and Synergies*, 32 FIN. MGMT. 5, 7–8 (2003); Ulrike Malmendier & Geoffrey Tate, *Who Makes Acquisition? CEO Overconfidence and the Market's Reaction* (Stanford Univ., Working Paper, 2003),

prices often do not reflect value;[272] (b) there is substantial controversy regarding whether mergers, on average, create or destroy shareholder value;[273] (c) many hostile takeovers result in financial debacles;[274] and (d) a substantial percentage of takeovers occur for strategic reasons, such as that

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available at http://ssrn.com/abstract=470788 (finding a strong role played by CEO overconfidence in merger activity); Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197 (1986) (originating the hubris hypothesis).

[272] Blair notes:

> If one lesson of Enron and other corporate disasters in the last few years is that today's share price cannot be counted on to reflect the true underlying value of the equity of a corporation, then the rise in share prices in the short run after the announcement of a hostile tender offer cannot necessarily be interpreted as reflecting a true increase in value that would result from the takeover. And if the rise in share prices is not uncontestable evidence that value will be created by a proposed takeover, then this undercuts a key contention of takeover advocates who had argued that the "market for corporate control" provides sufficient discipline to be sure that corporate officers and directors use their authority over corporate resources in ways that tend to maximize value creation by corporations.

Blair, *supra* note 258, at 894.

[273] *See* Anup Agrawal et al., *The Post-Merger Performance of Acquiring Firms: A Re-Examination of an Anomaly*, 47 J. FIN. 1605, 1611–12 (1992) (finding tender offer acquirers perform poorly after the acquisition, particularly if it is a cash offer); Paul Andre et al., *The Long-Run Performance of Mergers and Acquisitions: Evidence from the Canadian Stock Market*, 27 FIN. MGMT. 27, 41 (2004) (finding that over the three-year post-event period, Canadian acquirers significantly underperformed); Paul M. Healey et al., *Which Takeovers are Profitable? Strategic or Financial?*, 38 SLOAN MGMT. REV., Summer 1997, at 45, 55 (finding that acquisitions are generally break-even investments and that friendly mergers tend to do better than hostile takeovers); Malmendier & Tate, *supra* note 271, at 1 ("The results of the empirical literature on the overall return to mergers . . . [suggests] that mergers may have no value on average."); Sara B. Moeller, Frederik Paul Schlingemann & Rene M. Stulz, *Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave* J. FIN. (forthcoming 2005), *available at* http://ssrn.com/abstract=571064 (finding that acquiring firm shareholders lost twelve cents per dollar spent on acquisitions—$240 billion—from 1998 through 2002). *But see* Andrade et al., *supra* note 266 (finding that hostile takeovers virtually disappeared in the 1990s and that the friendly mergers that occurred generally created value); ROBERT F. BRUNER, DEALS FROM HELL: M&A LESSONS THAT RISE ABOVE THE ASHES 14–16 (2005) (arguing that mergers tend to create value, but averages are distorted by a relatively few large deals that fail badly).

[274] The AT&T purchase of NCR is a classic example. *See* Jaikumar Vijayan & April Jacobs, *Warning Signs of a Merger Gone Bad*, COMPUTER WORLD, June 30, 1997, at 17 (noting clashes of corporate culture); Bart Ziegler, *NCR Gets Yet Another New Lease on Life*, WALL ST. J., Dec. 30, 1996, at B1 (noting huge overpayment by AT&T).

the shark and target are a good match in an industry that is consolidating,[275] further undermine the efficiency/market disciplining story. So does the fact that most top managers receive generous golden parachutes if they leave the acquired company and handsome bonuses if they stay with it. So does the fact that in recent years serial acquisitions have been used frequently to "mask deteriorating financial results . . . and to reap outside executive pay"[276] at companies such as Tyco, Waste Management, and WorldCom.

In the face of competitive pressure, potential acquirers are more likely to look for competent firms to acquire, not incompetent ones.[277] While the evidence regarding whether hostile takeover targets are underperforming is decidedly mixed,[278] there is certainly no conclusive evidence that targets tend to be run by incompetent managers.[279] Indeed, hostile bidders indicate that they seek well-managed companies rather than poorly-managed ones,[280]

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[275] *See* Bernard Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 609 (1989) (noting that tender offer waves often concentrate on troubled industries where even well-managed firms have struggled).

[276] *See* Gretchen Morgenson, *What Are Mergers Good For?*, N.Y. TIMES MAG., June 8, 2005, at 56.

[277] *See* John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1212 (1984) [hereinafter Coffee, *Regulating the Market*] (citing study indicating that eighty-four percent of bidders surveyed looked for excellent management in takeover target).

[278] *Compare* Julian Franks & Colin Mayer, *Hostile Takeovers and the Correction of Managerial Failure*, 40 J. FIN. ECON. 163, 175 (1996) (finding in a study of British takeovers that "performance of targets of hostile bids is not inferior to that of a nonmerging sample of firms matched on the basis of size and industry"); JOHN POUND, ARE TAKEOVER TARGETS UNDERVALUED? AN EMPIRICAL EXAMINATION OF THE FINANCIAL CHARACTERISTICS OF TARGET COMPANIES (1986) (finding that takeover firms are not particularly undervalued or underperforming when related to a randomly selected control group); G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?*, 55 J. FIN. 2599, 2638 (2000) (finding in study that "[w]hen trying to explain the occurrence of hostility [in takeover bids], the variables that are most likely to reflect poor target management . . . contribute little explanatory power"), *with* Randall Morck et al., *Characteristics of Targets of Hostile and Friendly Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 101 (Alan J. Auerbach ed., 1988) (finding that target firms are poorly performing but not necessarily undervalued by the market).

[279] *See* Lynn E. Browne & Eric S. Rosengren, *Are Hostile Takeovers Different?*, *in* THE MERGER BOOM 199, 224 (1987) ("[T]he unremarkable nature of hostile takeover targets and the absence of clear evidence of management failure casts doubt on the argument that hostile takeovers exert a useful discipline on managers generally.").

[280] *See* A.A. Sommer, Jr., *Hostile Tender Offer is Critical Issue for Congress*, LEGAL TIMES, Jan. 21, 1985, at 19, 21 ("Generally, it is not poorly run companies, but well-run ones, that find themselves targets."); W.T. Grimm & Co., 1984 MERGERSTAT

and they typically retain the incumbent management team to the extent feasible.[281]

Furthermore, no shark ever selected a target because its managers refused to reincorporate in a jurisdiction with more efficient law. For all of these reasons, it seems clear that hostile takeovers are not closely related to manager performance and are totally unrelated to whether managers are choosing efficient legal regimes. If takeovers are not closely related to manager performance, and they clearly are not, then they can hardly serve a disciplining function.[282] They cannot and do not sufficiently encourage corporate managers to scout around for the most efficient corporate or securities law.

e. *Investors Cannot Accurately Value Risk*

Some regulatory competition proponents are realistic enough to realize that managers often select legal regimes that are less than optimal in terms of promoting shareholder interest. They assume that some issuers will signal their quality by opting into regimes with mandatory full disclosure and strong antifraud protection, that others will signal lack of quality by opting into regimes with lesser levels of disclosure and protection, and that investors will efficiently discount the shares of the latter corporations. This assumption is consistent with strong versions of signaling theory,[283] but signaling theory is predicated upon several often unrealistic assumptions[284] and is not effective

REVIEW 7 (noting that "[t]he acquired companies, in most cases, ranked first or second within their industries").

281 *See* Robert W. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 36 CASE W. RES. L. REV. 248, 254 n.18 (1985) (noting that most bidders "try to encourage [target managers] to remain in place after the takeover"); David J. Ravenscraft & F.M. Scherer, *Mergers and Managerial Performance*, *in* KNIGHTS, RAIDERS & TARGETS 194, 196 (John C. Coffee et al. eds., 1988) (reporting that none of the hostile bidders in their study "intended to purge the acquired firm's managerial ranks").

282 *See generally* Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, but Not Too Late*, 43 AM. U. L. REV. 379, 419–22 (arguing that hostile bids do not serve salutary disciplining function); Prentice & Langmore, *supra* note 270, at 420–25 (same); Cynthia A. Williams & John M. Conley, *An Emerging Third Way?: The Erosion of the Anglo-American Shareholder Value Construct* 6 n.20 (Univ. N.C Legal Studies Research, Paper No. 04–09, 2004), *available at* http://ssrn.com/abstract=632347 (noting that if the takeover markets are supposed to serve a disciplining function, they do it very badly).

283 *See* Stephen A. Ross, *Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory*, *in* ISSUES IN FINANCIAL REGULATION 177–202 (Franklin R. Edwards ed., 1979) (discussing signaling theory generally).

284 Among these assumptions are (a) no fraud, (b) disclosure is costless, (c) the investor knows the scope of information that is actually available, and (d) investors

"[i]f disclosure signals are noisy, i.e., support more than one inference about the information provider. . . ."[285] Regulatory competition, by fragmenting the investment picture, makes it very difficult for quality issuers to send a signal of their quality,[286] and very difficult for investors to read those signals.[287]

In another article, I used behavioral decision theory to challenge the assumption that investors in a regulatory competition scheme will be able to efficiently price the various choices that issuing companies' managers make regarding listing.[288] Nonbehavioral arguments are just as persuasive. For example, economic theory provides that if one firm in an industry voluntarily discloses good news, the stock price of competitors should drop as investors draw unfavorable inferences from their failure to disclose. In real life, however, the stock prices of competitors tend to stay the same or even increase.[289] Even if the stock price of other firms did drop, there is no guarantee that the market would not impose too great a discount.[290] When companies that are competitors disclose different things at different times in different formats, which regulatory competition encourages, it is exceedingly difficult for investors to draw proper inferences.

Thus, although many proponents of regulatory competition assume that investors will be able to rationally and accurately discount for issuer decisions to list in minimum-disclosure, fraud-friendly jurisdictions, this assumption is inaccurate. As Jackson has asked: "[C]ould capital markets be expected to price, in any meaningful sense, differences between French and

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understand and accurately process the information that is provided. None of these assumptions is necessarily accurate. *See* Franco, *supra* note 188, at 262–64 (discussing the assumptions), 265–76 (debunking the assumptions).

285 *Id.* at 264.

286 Rock points out that "[t]he danger is that regulatory competition may lead to fragmentation and thereby undermine the ability of any regulatory system to offer issuers the opportunity to commit credibly to maintain a given level of disclosure indefinitely." Rock, *supra* note 184, at 695.

287 Regulatory competition will likely create the bizarre result that an investor's Dell stock will be governed by a totally different set of disclosures and protections than her HP stock. How does an investor value those differences?

288 *See* Prentice, *Strong SEC, supra* note 3, at 40–41 and accompanying text.

289 *See, e.g.*, G.J. Clinch & N.A. Sinclair, *Intra-industry Information Releases: A Recursive Systems Approach*, 9 J. ACCT. & ECON. 87, 89–105 (1987) (finding stock price increase for nondisclosing competitors); Baruch Lev & Stephen H. Penman, *Voluntary Forecast Disclosure, Nondisclosure and Stock Prices*, 28 J. ACCT. RES. 49, 74 (1990) (finding no stock price reaction for nondisclosing firms).

290 *See* Stephen J. Choi, *Selective Disclosures in the Public Capital Markets*, 35 U.C. DAVIS L. REV. 533, 550 (2002) [hereinafter Choi, *Selective Disclosures*] (suggesting that this might happen).

Malaysian securities regulation?"[291] Even pricing the difference between Delaware's laws and New Jersey's is difficult, especially given Delaware's surfeit of open-ended rules that grant courts wide latitude for interpretation and for imposition of fact-specific determinations.[292]

A decision by an American company to list in Italy or Paraguay sends a very obscure signal. Does listing in a jurisdiction with few antifraud protections mean that the company intends to commit fraud, or only that it is trying to reduce its liability insurance costs?[293] Or perhaps to hire managers who do not wish to work for it in a higher liability regime? And what does it mean that a manager does not wish to work for this company except under circumstances of complete protection from fraud liability?[294] Is she just risk averse or does she have a slothful nature and/or sinister motives?

Consider that many companies have recently complained about the costs of Sarbanes-Oxley's § 404 requirements regarding internal financial controls.[295] This is certainly a reasonable complaint, and investors may well think nothing ill of companies that choose to deregister with the SEC and stop complying with mandatory financial disclosure requirements for registered companies. However, a recent study indicated that while most strong firms are not considering "going dark," managers of poorly

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[291] *See* Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQUIRIES LAW 649, 661 (2001).

[292] *See* Ehud Kamar, *A Regulatory Theory of Indeterminancy in Corporate Law*, 98 COLUM. L. REV. 1908, 1913–23 (1998); McDonnell, *Stuck*, *supra* note 68, at 702 ("There is a fairly widespread complaint that [Delaware] law has become somewhat arbitrary, complex, and hard to predict.").

[293] Similarly, does listing in a jurisdiction that lacks comprehensive mandatory disclosure mean that the company has something illicit to hide? Or is it just trying to hide information that would be useful to its competitors? Because there can be legitimate reasons not to disclose, investors cannot just "assume the worst" when companies choose not to disclose. "In other words, competitive forces negate the ability of the market to induce managements to provide full disclosure by punishing non-disclosure." Goshen & Parchomovsky, *supra* note 91, at 44.

[294] *See* McDonnell, *Stuck*, *supra* note 68, at 694. McDonnell notes:

> If setting stock prices is more of a crap shoot than traditional law and economic analysis would have it, then it is quite possible that the chaos of trying to price a new company's stock accurately, taking into account hundreds of idiosyncratic factors, will completely swamp out any effect the state of incorporation may have on the price.

Id.

[295] The SEC is, at this writing, looking at ways to minimize the costs that § 404 imposes upon market participants. *See, e.g.*, Andrew Parker, *Donaldson May Bend on Sarbanes-Oxley*, FIN. TIMES, Feb. 11, 2005, at 27.

performing firms may be choosing to do so in order to hide their struggles or to increase their private control benefits.[296] Another study found that while companies are complaining of excessive regulatory burdens following Sarbanes-Oxley, the costs of being public remain a relatively insignificant factor in decisions to go private.[297] Thus, while the market is taking a negative view of firms that are voluntarily delisting, it is probably not being sufficiently hard on those whose managers are delisting for private control reasons, but is being too hard on firms that are delisting because of Sarbanes-Oxley's costly requirements (but cannot be distinguished from the firms that are delisting for more sinister reasons).

Ultimately, Professor Cox is correct to argue that the fact that capital markets are noisy "does not support subjecting investors to multiple disclosure standards."[298] Ruder agrees, noting that "[i]t is difficult to imagine how an investor would be able to judge the effectiveness of different regulatory regimes, much less quantify that knowledge in a manner allowing the investor to change the purchasing or selling price of a particular security."[299] Absent a regime of mandatory disclosure applicable to all issuers, less-than-candid issuers can manipulate investors by use of timing opportunism, selective disclosure, and less transparent or less comparable disclosure of information.[300]

To the extent that issuer choice is based on an assumption that "rational and informed investors will increase their willingness to pay for securities

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[296] Christian Leuz, Alexander J. Triantis & Tracy Yue Wang, *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations* (unpublished working paper, Nov. 2004), *available at* http://ssrn.com/abstract=592421.

[297] *See* Peter C. Hsu, *Going Private–A Response to an Increased Regulatory Burden?* 45 (UCLA Sch. of Law, Law & Econ. Research, Paper No. 04–16, 2004), *available at* http://ssrn.com/abstract=619501 ("At the end, only very few companies probably undertook a going private because of the primary reason of saving costs of being public . . . .").

[298] Cox, *supra* note 79, at 1234.

[299] David S. Ruder, *Reconciling U.S. Disclosure Policy with International Accounting and Disclosure Standards*, 17 NW. J. INT'L L. & BUS. 1, 10 (1996); *see also* Uri Geiger, *Harmonization of Securities Disclosure Rules in the Global Market—A Proposal*, 66 FORDHAM L. REV. 1785, 1794 (1998) ("If the standards of many nations were accepted in one market, it would be difficult for investors to compare their investment opportunities.").

[300] Franco, *supra* note 188, at 285–89.

The benefits of comparability are difficult to overstate. *See* Ian P. Dewing & Peter O. Russell, *Accounting, Auditing and Corporate Governance of European Listed Countries: EU Policy Developments Before and After Enron*, 42 J. COMMON MKT. STUD. 289, 289 (2004) ("Robust, comparable and transparent information is fundamental to the successful operation of the European Union's (EU) internal market.").

from issuers that adopt valued investor protections,"[301] the fact that behavioral studies demonstrate that investors are often far from rational—that the judgment biases of even sophisticated institutional investors "are not merely isolated quirks, rather, they are consistent, deep-rooted, and systematic behavioral patterns"[302]—undermines the entire concept.

Alternatives to SEC-required disclosure are not appealing. If mandatory disclosure were eliminated and replaced by private contracting, each investor would have to bargain with each seller over the information to be disclosed. But there is no guarantee that the information would be presented in a comparably detailed and formatted way. The consequences for transaction costs would be unfortunate. Romano herself admits that even institutional investors are not skilled at obtaining private information possessed by firms,[303] and that institutional investors find it more cost-effective to have issuers disclose information than to find it themselves.[304]

In a regulatory competition regime, in which companies can choose state regimes or international regimes with different requirements as to subjects to be addressed, different rules for what must be disclosed about those subjects, different accounting rules, and different antifraud rules, investors will incur much greater search costs in order to gather such information, and it is unlikely that disclosure comparability will ever occur.[305]

For example, eliminating uniformity of accounting rules would be hugely disadvantageous to most investors. Comparability is so important in accounting rules that the SEC works constantly with the international community in an attempt to move in the direction of more nation-to-nation standardization (with the SEC serving as a gatekeeper to ensure certain minimum levels)[306] and coordinated enforcement efforts.[307] Standardization

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[301] Stephen J. Choi, *Assessing Regulatory Responses to Securities Market Globalization*, 2 THEORETICAL INQUIRIES LAW 613, 616 (2001).

[302] Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 STAN. L. REV. 1, 2 (2003).

[303] Romano, *Empowering Investors*, *supra* note 48, at 2416.

[304] *Id.* at 2417.

[305] SEC requirements set a standard that investors adopt. Because of that, domestic issuers of exempt securities frequently will voluntarily disclose much of the information that the SEC would have required had the securities not been exempt. Similarly, securities professionals in Europe make "U.S.-style" disclosures voluntarily because investors want them. Howell E. Jackson & Eric J. Pan, *Regulatory Competition in International Securities Markets: Evidence from Europe in 1999—Part I*, 56 BUS. LAW. 653, 685–86 (2001).

[306] Trachtman, *supra* note 106, at 12 (noting efforts of the International Accounting Standards Committee to create international accounting standards, of the International

and comparability increase the value of information,[308] and make investors more comfortable and more willing to invest.[309] Without standardization, most issuers will, to the extent possible, tend to choose their own standards in a strategic way to hide or minimize their particular problems and highlight their own advantages. The indisputable benefits of standardization and restricted strategic disclosure argue strongly for mandatory disclosure and directly "conflict with the notion of issuers selecting among the disclosure standards of different jurisdictions."[310]

Professor Romano has conceded the value of standardization and, when writing of her domestic state regulatory competition plan for securities law, suggests that "the most significant area of standardization, firms' financial reporting, would still be controlled by the private sector under the Financial Accounting Standards Board (FASB), and thus be consistent across firms complying with its rules."[311] Of course, if there is truly to be competition, then the states must be free to overrule FASB. California must be free to allow companies registering there to avoid expensing options, even as New York requires them to do so. Massachusetts must be free to require its companies to eliminate pooling when they merge, whereas Nevada must be free to allow it. As Coffee notes in the international issuer choice context, "one U.S.-incorporated company could adopt Italian accounting and disclosure standards; another Greek; and a third, Korean."[312]

When confronted with the "Tower of Babel" argument, Choi and Guzman, after touting the benefits of many choices for issuers, take the position that there actually will not be that many because "[d]omestic investors are likely to gravitate to their country's own securities regime."[313] In other words, the advantages of standardized and uniform accounting for

Organization of Securities Commissions to set minimum standards for non-financial disclosure, and of the SEC to keep the bar at an acceptable level).

307 *See* Diane P. Wood, *International Law and Federalism: What is the Reach of Regulation?*, 23 HARV. J.L. & PUB. POL'Y 97, 107 (1999) (noting SEC approach of coordinated enforcement).

308 Gerard Hertig et al., *Issuers and Investor Protection*, *in* THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 193, 206 (Reiner R. Kraakman et al. eds., 2004).

309 *See* Mark T. Bradshaw et al., *Accounting Choice, Home Bias, and US Investment in Non-US Firms*, 42 J. ACCT. RES. 795, 835 (2004) (finding that foreign investors are more likely to invest in firms that have accounting systems with which they are familiar).

310 Franco, *supra* note 188, at 319.

311 Romano, *Empowering Investors*, *supra* note 48, at 2394.

312 Coffee, *Racing Towards the Top*, *supra* note 5, at 1827.

313 Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 926 (1998) [hereinafter Choi & Guzman, *Portable Reciprocity*].

financial information are so obvious that Professor Romano is willing to forfeit the underlying premise of regulatory competition in order to preserve them.[314] Choi and Guzman emphasize diversity of issuer choice until push comes to shove, and then they concede the considerable benefits of standardization and suggest that regulatory competition need not be so competitive after all. Choi has admitted that:

> [t]o the extent at least some analysts are truthful in their opinions and the market is unable to distinguish among truthful and corrupted analysts perfectly, some corrupt analysts nevertheless may be successful in fooling the market. Rational purchasers of securities that realize this possibility will then demand a discount of *all* firms.[315]

Despite warning signals, even the most sophisticated investors rode their Enron stock right into the basement.[316] How are they to price the much less indirect signals that come from firms selecting among a wide variety of disparate securities regimes?

2. *Shareholder Vote is Not a Significant Restraint*

Except when the "outrage factor" moves directors to exert their legal discretion, officers run public corporations. Shareholders have theoretical influence in that they vote for directors, have the right to vote regarding

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[314] Because issuers who do not have a good story to tell and who opt into a regime of little disclosure and less fraud enforcement will not wish to voluntarily disclose that information, even Romano recognizes that something must be done. She proposes in the state-competition version of her plan that issuers and brokers be required to inform investors of the securities domicile applicable to that security. Romano, *Empowering Investors*, *supra* note 48, at 2413. Choi and Guzman similarly recognize that issuers cannot be trusted to disclose this information and that investors may not demand it, so they similarly recommend that domestic legislatures pass laws requiring such disclosure. Choi & Guzman, *Portable Reciprocity*, *supra* note 313, at 926.

Also, because issuers who do not have a good story to tell may wish to issue their shares under a regime of full disclosure and fraud enforcement and then, having gotten everybody's money, switch to a regime of little disclosure and less fraud enforcement, Romano suggests that shareholder approval be required for such a change in domicile. Romano, *Empowering Investors*, *supra* note 48, at 2415–18. The need to prevent managerial opportunism in such a way should undermine faith in a regime predicated on the assumption that managers will opt for more disclosure so as to bond their firms' reputations. If managers cannot be trusted to stay in the most efficient regime, how can they be trusted to use it in the first place?

[315] Choi, *Selective Disclosures*, *supra* note 290, at 551 (emphasis added).

[316] Ribstein, *supra* note 54, at 8–9.

major organic corporate changes, have the right to file derivative suits, and the like. But, as Thompson and Sale have pointed out, "[s]hareholders vote, sell, and sue, although each action occurs only in carefully measured doses that, even collectively, do not change the ultimate control of the corporation."[317]

This general truth is especially accurate regarding incorporation decisions. Shareholders do not choose where their company will incorporate, by which jurisdiction's law it will be governed, or on which exchange it will list. Furthermore, shareholders cannot now initiate a change in state of incorporation[318] or a change regarding where the firm's shares are listed. Nor would they be able to do so under most suggested regimes of state and international securities law competition.

Because shareholders are so impotent in this regard, Delaware currently has little incentive to cater to shareholder interests in a competitive regime for corporate law, and other states, nations, and exchanges will similarly lack incentive to create value for shareholders in a regime of competition to provide securities law.[319]

Many arguments about regulatory competition assume that law providers will have an incentive to protect shareholder interests because shareholders will reject a management initiative to reincorporate in Delaware (or to be governed by the securities law of Peru) if it is not in their best interests.[320] But there is little evidence that this is so.[321]

Individual shareholders of public corporations simply do not have a rational incentive to inform themselves regarding whether a management-

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[317] *See* Thompson & Sale, *supra* note 61, at 865.

[318] *See* Choi & Guzman, *Choice*, *supra* note 249, at 972 ("Without management support for reincorporation, the issue is not subject to a shareholder vote.").

[319] Romano has discussed the statistics regarding shareholder proposals about changes of the state of incorporation without noting that they demonstrate that the issue is totally off the radar screen of most shareholders. ROMANO, ADVANTAGE, *supra* note 35, at 72 (pointing out that from 1987 to 1994 only ten of 2042 shareholder proposals sought reincorporation).

[320] *See* Barzuza, *supra* note 32, at 163–65.

[321] This fact renders Barzuza's price considerations analysis of regulatory competition much less persuasive than it would otherwise be, notwithstanding his spirited defense of shareholder input. *See id.* at 171–74. Barzuza argues that Delaware is constrained in how far it can trend toward the bottom because although enacting antishareholder provisions will attract management proposals for reincorporation to Delaware, it will cause shareholders to resist reincorporation there unless benefits exceed the costs of Delaware's franchise tax. However, there is little evidence that shareholders pay any attention to the level of Delaware's franchise tax or that they would have an ability to rationally monetize the value of various forms of state law that Delaware might adopt.

initiated change in state of incorporation (or jurisdiction of securities law or exchange of listing) is actually in their best interest.[322] They suffer from a severe collective action problem.[323] Typically, no individual shareholder has sufficient incentive to invest optimally in researching issues to be voted upon.[324] These considerations certainly apply to votes regarding reincorporation or choice-of-regime decisions, which on their face seem not terribly momentous.[325]

A fall-back argument is that even if shareholders cannot vote effectively regarding reincorporation decisions or relisting decisions, they can at least punish directors when bad decisions are made. But this also seems unlikely. Shareholders almost always vote for the incumbent slate of directors.[326] Even if they are unhappy with decisions of their current directors, they almost

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322 *Id.* at 142.

323 Coates points out that shareholders of public corporations face two collective action problems:

> First are costs of communication, negotiation, and coordination—which rise dramatically as the number of shareholders increases. If shareholders differ even modestly in how they trade off risk, liquidity, and control, attempts to negotiate and coordinate as few as thirty dispersed shareholders are daunting. Second is the problem of free-riding. Those attempting either to control the company or coordinate shareholders will face the risk that the cost will fall on that shareholder, but benefits will be shared.

John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 849 (1999); *see also* Bebchuk, *Desirable Limits*, *supra* note 11, at 1460 ("[T]he requirement of shareholder approval is frequently an ineffective constraint because of problems of information, collective action, and distorted choice.").

324 Camara, *supra* note 264, at 1472 ("[Individual shareholders do] not have sufficient incentive to invest optimally in investigating the consequences of potential corporate actions when these consequences accrue to the corporation rather than to the shareholder individually.").

Camara also notes that "[e]ven if shareholders were to invest irrationally in optimal investigations, the result would be undesirable because their many costly investigations would be redundant." *Id.* at 1474.

325 *See* Choi & Guzman, *Choice*, *supra* note 249, at 987.

326 *See* Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 28 n.118 (2002) (noting that proxy contests "are so costly and their outcome so uncertain that they are invoked only episodically"); Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 310 (1999) ("In both theory and practice, however, shareholders' voting rights—at least in publicly-traded corporations—are so weak as to be virtually meaningless.").

never replace them.[327] Nor is it feasible for them to consider doing so, in most cases.[328] Furthermore, reincorporation or relisting decisions are simply unlikely to be high on a list of shareholder priorities even if coordination and other problems could be overcome.

For all of these reasons, shareholders overwhelmingly defer to directors' judgment. For example, they approve ninety-nine percent of stock option plans put before them,[329] even though such options have become a mechanism for wholesale misappropriation of shareholder assets.[330] Shareholders of acquiring corporations in stock-for-stock mergers almost always approve them, even though results of such deals are decidedly mixed.[331]

And shareholders automatically vote for most reincorporation proposals as well.[332] Even when it is obvious that management is moving to a

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[327] Lucian Arye Bebchuk, *Designing a Shareholder Access Rule* 1 (Harvard John M. Olin Ctr. for Law, Econ., & Bus., Discussion Paper No. 461, 2004), *available at* http://ssrn.com/abstract=511882 ("Although shareholder power to replace directors is supposed to be an important element of our corporate governance system, it is largely a myth."); Lucian Arye Bebchuk, *The Case for Shareholder Access to the Ballot*, 59 BUS. LAW. 43, 45 (2003) ("Attempts to replace directors are extremely rare, even in firms that systematically under perform over a long period of time.").

[328] Paredes, *supra* note 246, at 24 (noting that throwing out incumbent managers via a proxy fight is not typically realistic "given the cost of running a proxy contest and the practical difficulties shareholders have coordinating in support of a slate of nominees to challenge the incumbent directors who typically are supported by, and in turn support, incumbent management").

[329] Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31, 58 (2000).

[330] Michael B. Dorff, *Softening Pharoah's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Rein in Executive Salaries*, 51 BUFF. L. REV. 811, 884 (2003) (noting that, in the area of executive compensation, "[t]he problem with elections is that they have proven largely ineffective as a counterweight to management's power").

[331] *But see* Timothy R. Burch, Angela Morgan & Jack G. Wolf, *Is Acquiring-Firm Shareholder Approval in Stock-for-Stock Mergers Perfunctory?*, 33 FIN. MGMT. 45, 45 (Winter 2004) (concluding that shareholders' votes are meaningful even though none in their sample failed and the average approval rate was ninety-five percent).

[332] Situations in which shareholders have vetoed proposed reincorporations are relatively rare. Such cases tend not to involve shareholders realizing that they are not well-served by the reincorporation. Rather, they involve rare confluences of political issues and the interests of nonshareholders, such as the Stanley Works decision not to reincorporate from Connecticut to Bermuda for tax reasons. The board withdrew that controversial proposal in the shadow of the Enron scandal and heavy pressure from labor groups and communities. *See* Virginia Groark, *Stanley Works Is Staying, and a Tax Issue Remains, Too*, N.Y. TIMES, Aug. 11, 2002, § 14CN at 1.

jurisdiction with tougher antitakeover laws in a bid to stifle tender offers that would benefit shareholders, defeats of management-backed reincorporation proposals are rare.[333]

Romano and others count on institutional investors to save the day, but this has not worked so far. Even if institutional investors desired to put in the effort to overcome the limitations caused by unsophisticated investors, it is questionable whether they could. And it is even more questionable whether they have the will to do so in the long run.[334] Most do not seem to have much desire to play a role in upgrading corporate governance.[335] They have repeatedly passed on opportunities to influence corporate behavior via shareholder proposals.[336] After Sarbanes-Oxley, they were "largely

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A decidedly unscientific study finds that when one searches "approv! w/20 of reincorporation" in Lexis-Nexis' News, All (English) data base, one gets 919 hits. When one searches "defeat! w/20 reincorporation" into the same data base, one gets twenty-two hits. When one searches "reject! w/20 reincorporation," one gets forty-four hits. Study performed December 14, 2004.

Institutional Shareholder Services (ISS) statistics on file with the author indicate that from 2001 to 2004, thirty-nine Russell 3000 companies put reincorporations up for shareholder vote. Thirty-four were approved. In all of the other five, many more shares were voted in favor of the reincorporation than against, but the proposals were apparently done in by abstentions. Two of the corporations successfully completed the reincorporations a year after the first unsuccessful vote.

[333] *See* Warren Vieth, *Fluorocarbon's Reincorporation Proposal Defeated*, L.A. TIMES, June 10, 1987, at 4:1. *See also* Greenwood, *supra* note 88, at 454 (noting that shareholder votes regarding reincorporations are largely a formality, for managers control the decision).

[334] Romano suggests that institutional investors dominate and will prevent issuers from switching mid-stream from the pro-investor regime they began with, to a less protective regime. However, Choi points out that

> unsophisticated investors may have a negative effect on other shareholders during a shareholder vote, reducing the effectiveness of shareholder voting as a means of aligning the incentives of managers and shareholders. Unsophisticated investors, for example, are less likely to be informed on a particular vote or to own sufficient shares to consider it worthwhile to make the investment to become so informed.

Choi, *Issuer Choice*, *supra* note 119, at 852.

[335] *See* Adrian Michaels & Deborah Brewster, *Waiting Outside the Boardroom: Will Big US Shareholders Use Their Power to Hold Company Directors to Account?*, FIN. TIMES, Oct. 7, 2003, at 21 ("[T]here is very little evidence that the people who own most shares in US companies—the large institutional shareholders—are hankering for a greater say in the nomination of directors.").

[336] *See id.* (noting that "institutional investors are often criticized for not making use of their existing powers to influence corporate decision-making" and observing that only thirty of 800 shareholder governance proposals put forth in 2003 came from mutual funds and pension funds).

inarticulate" regarding corporate governance reforms.[337] One problem may be motivation. Large mutual funds are courting companies seeking investment management fees, so they are loath to rock the corporate governance boat.[338] Similar motivations may account for their failure to take a stand against egregiously excessive executive pay.[339] Another problem may be that institutional investors are generally subject to the same cognitive and behavioral limitations as other investors.[340]

The bottom line is that there are too many situations in which the assumption that the shareholders will restrain managers who do not choose the jurisdiction with the law that best favors shareholder interests does not hold.

VII. THE END OF SECURITIES LAW?

Thus far, the tone of this Article has been somewhat depressing. Self-serving managers mistreat shareholders and are, perhaps, aided and abetted by regulators. Everywhere we look the regulatory competition race is modest, but descending. Woe unto us all!

However, as I have noted elsewhere,[341] around the world there has been a strong trend toward the top in the past few years. European and Asian countries have been aggressively moving toward what I call the "strong-SEC" model developed in the United States. Virtually all developed nations have created central regulatory authorities, banned insider trading, required more disclosure by issuers and other actors in the securities markets,

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[337] Adrian Michaels, *Funds Under Fire for Lack of Initiative*, FIN. TIMES, Oct. 7, 2003, at 34 (quoting governance expert Ira Millstein).

[338] *See* Michaels & Brewster, *supra* note 336, at 21 (quoting corporate governance lawyer Ira Millstein for the observation that "there are subtle conflicts working at every level").

[339] Dorff suspects the reason that the market has not cured excessive compensation is that the big institutional investors who could do something (a) diversify their portfolios and use indexing, which shields them from the effects of any one company, and (b) typically have strong ties to companies in which they have substantial investments. Dorff, *supra* note 331, at 835–37.

[340] Institutional investors seem to be easily fooled by earnings management, for example. *See* Reed Abelson, *Truth or Consequence? Hardly*, N.Y. TIMES, June 23, 1996, at F1 (noting that most companies manipulate financial statements and that the markets are influenced by those manipulated numbers). Another study finds that professional investors exhibit even more myopic loss aversion than student subjects. *See* Michael S. Haigh & John A. List, *Do Professional Traders Exhibit Myopic Loss Aversion? An Experimental Analysis*, 60 J. FIN. 523 (2005).

[341] *See* Prentice, *Strong SEC*, *supra* note 3, at 51–56.

punished fraud more severely, and dramatically improved corporate governance. There has been a convergence toward American-style securities law[342] and toward what might be considered the "best practices" of American corporate governance.[343] What accounts for this? How has the race-to-the-bottom pressure exerted by the traditional regulatory competition model's reliance on corporate managers to pick the regulatory regime been overcome? In addition to the fact that regulatory competition is a very weak force in the securities law universe, I credit six factors.

First, is the obvious success of the American model. American capital markets are the widest, deepest, and most efficient in the world and many credit their success to the aggressiveness of the SEC and the effectiveness of the legal regime it enforces.[344]

Second, is the very substantial body of cross-national empirical evidence that has been accumulating in recent years, strongly indicating that countries following the strong-SEC model by requiring disclosure, punishing fraud, prohibiting insider trading, and enforcing laws via a strong central agency supplemented by private rights to sue will generally have stronger capital markets and more vibrant economies.[345]

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[342] *See id.* at 56 and accompanying text.

[343] *See generally* REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH (2004); CONVERGENCE AND PERSISTENCE IN CORPORATE GOVERNANCE (Jeffrey N. Gordon & Mark J. Roe eds., 2004).

[344] *See* Rock, *supra* note 185, at 694 ("Investment capital is available all over the world, yet it is the U.S. capital markets, under the SEC disclosure system, that are without peer in the public financing of new enterprises, high tech and otherwise, domestic and foreign.").

[345] Cross and I have reviewed this empirical evidence and added modestly to it ourselves. *See* Prentice & Cross, *supra* note 3, at 31–51. *See also* Laura Nyantung Beny, *Do Insider Trading Laws Matter? Some Preliminary Comparative Evidence*, 7 AM. L. & ECON. REV. 144, 144 (finding that countries with stronger insider trading laws enjoy "more diffuse equity ownership, more accurate stock prices, and more liquid stock markets") (emphasis omitted); Utpal Bhattachayra & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75, 75 (2002) ("[T]he cost of equity in a country, after controlling for a number of variables, does not change after the introduction of insider trading laws, but decreases significantly after the first prosecution."); Hazem Daouk, Charles M.C. Lee, & David Ng, *Capital Market Governance: How Do Security Laws Affect Market Performance?* 26 (unpublished working paper, Feb. 28, 2005), *available at* http://ssrn.com/abstract=702682 ("[I]mproved security laws are associated with decreased cost of capital, higher trading volume, greater market depth, increased U.S. ownership, lower price synchronicity, and reduced IPO underpricing."); Luzi Hail & Christian Leuz, *International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?* 4 (ECGI Law Working Paper Series, Working Paper No. 15, 2003; AFA 2005 Philadelphia Meetings; Rodney L. White Ctr. for Fin. Res., Working Paper No. 17–04, 2004) *available at*

Third, give credit to the federal government. As noted earlier, the primary pressure upon Delaware to encourage it occasionally to protect shareholders rather than just to cater to managers' interests is the countervailing pressure of potential federal regulation. In times of crisis, if Delaware does not act aggressively to protect investors, the SEC (or even Congress) has done so and certainly may do so again.[346]

The SEC also raises the practices of nations around the world in three ways. Initially, the SEC requires foreign companies that wish to sell their securities to American investors to meet most American standards. This necessarily has an impact upon these companies' practices back home.[347] Several years ago, large German companies that desired to list in the U.S. encouraged German regulators to switch to Anglo-American style accounting so that they would not have to prepare two completely disparate sets of books.[348] Furthermore, the SEC is somewhat aggressive in applying its antifraud mechanisms to punish fraud occurring abroad that impacts American markets and to protect foreign investors who are injured by fraud that occurs in the U.S.[349] This has a ripple effect regarding acceptable practices. Finally, the SEC jawbones foreign governments. For many years it has been a strong advocate for more disclosure, prohibitions on insider trading, and other antifraud activities.

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http://ssrn.com/abstract=641981 (finding that countries with extensive securities regulation and strong enforcement mechanisms exhibit lower levels of cost of capital than nations with weak legal institutions, even when other factors are controlled for); Rafael La Porta, Florencio Lopez de Silanes & Andrei Shleifer, *What Works in Securities Laws?* 1 (Tuck Sch. of Bus., Working Paper No. 03–22; AFA 2005 Philadelphia Meetings, 2003), *available at* http://ssrn.com/abstract=425880 (finding that disclosure and liability rules benefit stock markets); Ross Levine, *Law, Finance, and Economic Growth*, 8 J. FIN. INTERMEDIATION 8, 33 (1999) ("Countries where corporations publish relatively comprehensive and accurate financial statements have better developed financial intermediaries than countries where published information on corporations is less reliable.").

[346] *See supra* notes 99–100 and accompanying text.

[347] For example, Baums notes that when German companies list on foreign exchanges, such as those in America, they must comply with higher standards, and this internationalization brings the expectations of multinational investors into the German market. *See* Theodor Baums, *Company Law Reform in Germany* 2 (unpublished working paper, July 4, 2002), *available at* http://ssrn.com/abstract=329962.

[348] *See* David Waller, *Daimler-Benz Gears Up for a Drive on the Freeway*, FIN. TIMES, Apr. 29, 1993, at 18.

[349] *See* Sue Reisinger, *SEC Takes Aim Beyond U.S. Borders: As the Markets Become More Global, So Does the Enforcement*, NAT'L L.J., Jan. 26, 2004, at 8, 12 (noting the SEC's aggressive role in Parmalat and Vivendi scandals).

Fourth, give additional credit to Sarbanes-Oxley. The most important reform of American securities laws in sixty years, by being aggressively extraterritorial, has been credited for bringing about many changes:

- Far-reaching changes in the way major accounting and auditing firms are supervised around the world;
- A push toward aligning corporate governance in Europe and other parts of the world with the standards and practices prevailing in the capital market-based U.S. financial and corporate system;
- EU reform initiatives to modernize company law and enhance corporate governance aimed at strengthening shareholders' rights, reinforcing protection for employees and creditors, increasing the efficiency and competitiveness of European business, and boosting confidence in capital markets; and
- Governments willing to bring forward on a national level long-delayed legislation on financial disclosure for corporate management and tougher regulations designed to curtail fraud in the financial industry.[350]

A fifth factor is Enron-like scandals occurring in Europe.[351] Scandals involving Parmalat in Italy,[352] Royal Ahold in Holland,[353] Vivendi in France,[354] and a number of companies in Germany[355] put pressure on those

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[350] Klaus C. Engelen, *Lemons* Into *Lemonade: How the United States Turned an Ugly Accounting Scandal Into a Mighty Lever for Global Financial Oversight and Regulation*, INT'L ECON., Sept. 22, 2004, at 56–57.

[351] *See* Klaus C. Engelen, *Preventing European "Enronitis,"* INT'L ECON., June 22, 2004, at 40 (noting that Enron and comparable scandals in Europe place European leaders "under mounting pressure from global markets and an increasingly critical general public" to speed up modernization of financial market oversight structure).

[352] *See* Tobias Buck, *Alarm Spreads as Virus Crosses the Pond*, FIN. TIMES, Dec. 15, 2004, at 2 ("[T]he general drift is unmistakable: after Parmalat, reform of Europe's corporate governance rules is firmly under way."); Guido Alessandro Ferrarini & Paolo Giudici, *Financial Scandals and the Role of Private Enforcement: The Parmalat Case* 56 (ECGI Law Working Paper Series, Working Paper No. 40, 2005), *available at* http://ssrn.com/abstract=730403 (noting how the Parmalat scandal highlighted Italy's (and Europe's) need to reform in order to be more facilitative of private efforts to enforce securities laws).

[353] *See* Brian Hanney, *Ahold: The European Enron?*, ACCOUNTANCY, Apr. 1, 2003, 42, at 42–43 (analyzing Ahold scandal).

[354] *See* Samer Iskandar, *Financial Profile: Michel Prada, AMF Chairman, Keeps France on the Road to Radical Reform*, FINANCIALNEWS ONLINE, Oct. 24, 2004 (noting

nations, as the Enron scandals put pressure on the American Congress, to improve securities laws and corporate governance in order to restore faith in the capital markets.

Sixth, as Kamar has recently observed, although European nations do not compete for incorporations, that very fact makes it necessary for them to compete for infusions of capital.[356] The American experience, the empirical evidence, and common sense all tell these nations that, in order for their home companies to compete for capital that flows with increasing fluidity across international borders, they must erect legal structures to protect investors. Managers and majority shareholders who may profit more from operating under the old rules are unlikely to push for such reforms in sufficient numbers. Fortunately, the European nations especially have performed their own intensive studies of capital market development. The Vienot and Marini reports in France, the Higgs Report in England, the Aldama Report in Spain, and various EU reports[357] are examples. Almost without exception, these reports recommend reforms that closely emulate the strong-SEC model and many of the reports' recommendations have already been implemented. As noted, virtually every major European and Asian government has in recent years created a central agency to enforce securities laws, increased the amount of mandatory disclosure, stiffened penalties for fraud, enacted insider trading prohibitions, and made it easier for injured investors to vindicate their rights.[358]

This is not the type of regulatory competition envisioned by Romano and others.[359] It mandates less, not more, issuer choice. It involves more, not less,

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that French reform was catalyzed by the need to restore market confidence after three-year bear market interspersed with scandals such as Vivendi's).

[355] *See generally* Baums, *supra* note 348 (noting how scandals involving German companies seemingly necessitated significant legal reform).

[356] *See* Kamar, *Beyond Competition, supra* note 121.

[357] *See* Richard Donkin, *Steps Towards Design of the Perfect Board: The Biggest Impact of an Imminent Report Is Likely to Be on the Degree of Independence and the Quality of Supervision Expected of Non-Executives*, FIN. TIMES, Jan. 16, 2003, at 12 (discussing England's 2003 Higgs Report); Samer Iskandar, *Progressive is Impressive*, FIN. TIMES, June 14, 2000, at 8 (noting French improvements in corporate governance enacted since 1995 Vienot Report); *French Public Losing Confidence in Auditors*, THE ACCOUNTANT, Jan. 1997, at 4 (noting corporate governance proposals of France's 1996 Marini Report); *Spain: New Law for the Post-Enron Era*, INT'L ACCT. BULL., Sept. 12, 2003, at 11 (noting many changes for the accounting profession and corporate governance recommended by Spain's 2003 Aldama report).

[358] *See* Prentice, *Strong SEC, supra* note 3, at 51–56.

[359] Romano argues that the key point in favor of regulatory competition is that "no government entity can know better than market participants what regulations are in their interest, particularly as firms' requirements are continually changing with shifting financial market conditions." ROMANO, ADVANTAGE, *supra* note 35, at 45. The logical

governmental interference in the markets. Private contracting is only a small part of the picture. But this new movement means that European and Asian regulation is rapidly converging upon the American model that embodies what strongly appear to be "best practices" insofar as we can know them given our current state of knowledge. Most importantly, these reforms mostly involve governments setting thresholds for appropriate behavior, rather than allowing managers to choose the rules by which they will be governed. Unlike regulatory competition premised on managers' decisions to do what is in the best interests of their firm—when there is so much evidence that they too frequently do not—this new trend involves lawmakers looking around the world at what works in practice.

IX. CONCLUSION

Over the past quarter century many of the brightest minds in legal academia have been engaged in a quixotic quest to replace the current system of federal securities regulation with either regulatory competition or private contracting. The real world has paid little attention to the raging scholarly debate, and for good reason.

The key to making needed improvements in securities regulation does not lie in any regime of regulatory competition proffered thus far. There is strikingly persuasive evidence that states do not meaningfully compete to provide corporate law and have little reason to do so. Delaware won the battle for incorporations long ago and has only widened its lead over the last century. Therefore, even Delaware has little motivation to create innovative laws to attract incorporations and certainly other states do not. Corporate regulatory competition is a pleasant dream, but little more.

To the modest extent that competition does exist, it tends to pander to the interests of those who make the incorporation decisions—corporate managers. It tends not to advance the interests of shareholders. Only the constant worry that bad behavior will cause additional federal encroachment prevents Delaware lawmakers from further eviscerating shareholder interests.

For these reasons, those interested in the future of securities regulation should not look to corporate regulatory competition as a model for future action. There is little reason to think that states or nations will be interested in competing to provide securities law. There is even less reason to think that if states, nations, or exchanges do compete to provide securities law that the results will be efficacious. This Article has examined the evidence regarding

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extension of this argument is that there should be no regulation at all, for if the parties are wise enough to choose among regimes with various types of regulation and regimes with no regulation at all, they should do just fine making their own arrangements. *See* Trachtman, *supra* note 107, at 22 (pointing out that "this statement is really an argument against any regulation at all, but very little support is provided for this argument").

state competition to provide securities law, national competition to provide securities law, and domestic and international exchange competition for listings. In each area, the better evidence indicates that a meandering saunter to the bottom is much more likely than a vigorous hike to the top.

This Article has also explained why the pervasive trend in all of these forms of regulatory competition is downward. Corporate law and much of securities law exist to solve the agency problem. Yet regulatory competition simply assumes away this problem, claiming that firms know what is in their best interests better than governments. But the real choice is not between firms and the SEC, it is between managers and the SEC. Managers are in an inherent conflict of interest situation. The SEC is not. Corporate and securities rules exist largely to restrain managers, yet regulatory competition entrusts managers to select the rules by which their conduct will be governed.

All things being equal, managers do not wish to disclose, because they do not wish to be monitored any more than they have to be. They avoid antifraud laws, because they naturally prefer to escape liability. They would not voluntarily choose a regime that prohibits insider trading, because the practice is profitable. They do not embrace strong central securities agencies, because then all of these rules and prohibitions have bite.

Yet a formidable body of empirical evidence indicates that economies are stronger and capital markets are deeper and more efficient in nations in which securities law is stringent, disclosure is mandatory, fraud is punished, and insider trading is prohibited.[360] This is not the model that managers tend to choose voluntarily, but it is the model that works. Indeed, all around the world, countries wishing to improve their markets and economies are adopting and adapting the strong-SEC model, not looking to replace it. European and Asian nations are creating their own versions of the SEC, increasing disclosure requirements, banning insider trading, and stiffening penalties for securities fraud. Given difference of law, culture, and infrastructure, these efforts will be met with varying degrees of success, but as a general rule the trend is salutary.

It is therefore time to refocus attention upon improving the existing strong-SEC model. It will not be replaced any time soon.[361] While academics

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[360] Coffee, *Racing Towards the Top*, *supra* note 5, at 1763 n.15 (citing studies); Prentice & Cross, *supra* note 3 (citing studies and adding additional evidence).

[361] Even if it were not the best available option, path dependence considerations would ensure its survival. *See* Hillary A. Sale, *Gatekeepers, Disclosure, and Issuer Choice*, 81 WASH. U. L.Q. 403, 403 (2003); Tung, *Translation*, *supra* note 122, at 573–81. Pritchard has observed that "[g]overnment regulation is far too entrenched in the United States for self-regulation to be a likely alternative today." Pritchard, *Self-Regulation*, *supra* note 182, at 35.

can debate the finer points of regulatory competition, few, if any, serious market participants in the real world embrace it in any of its suggested forms as a viable vision of the future of securities regulation.[362] Those people in business who would theoretically profit from the diverse choices that would spring from regulatory competition (or from regimes of private contracting) in securities regulation have made clear their preference for exactly the opposite sort of regime—one of uniformity and coordination.[363]

While it would be an overstatement to claim that regulatory competition never exists or that its influence is inevitably pernicious, the capital markets will be best served by having our brightest minds focus upon improving rather than replacing the existing strong-SEC model.[364]

A sufficiently strong and coordinated move by business certainly could have an impact, but the harsh truth is that no issuers or securities industry groups seem particularly enamored of regulatory competition for securities law. *See* Tung, *Passports*, *supra* note 7, at 374, 388–89 (noting that the political pressure thwarting such regulatory competition will likely be much stronger than that supporting it).

[362] *See* Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 422 (2003) ("[T]he mandatory disclosure debate has been settled for seventy years, since the Securities Act of 1933 was adopted.").

[363] *See* John C. Coates IV, *Private vs. Political Choice of Securities Regulation: A Political Cost/Benefit Analysis*, 41 VA. J. INT'L L. 531, 537–43 (2001) (noting that both in domestic and international securities regulation, key economic actors seem to be adopting not regulatory competition "but its opposite"); Tung, *Monopolists*, *supra* note 5, at 1422 (noting the irony that "'corporate America'—issuers and institutional investors, who are supposed direct beneficiaries of issuer choice—implicitly reject it").

[364] I am not yet ready to take the strong-SEC argument to the potentially logical conclusion of recommending federal incorporation in the U.S., or a single worldwide securities regulator. Reasonable arguments could be made for both propositions, but I do not go there. Eliot Spitzer has demonstrated that there are at least some countervailing advantages to our crazy-quilt federalist system. *See* McDonnell, *Two Cheers*, *supra* note 63, at 140 ("[A]s a whole this mixed federal system of corporate law seems to work pretty well—at least as compared with any alternative on offer.").